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**From compliance to coping
Experiences of Chief Risk Officers in UK banks 2007-2009**

Miles, Roger

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***From compliance to coping:
Experiences of Chief Risk Officers
in UK banks 2007-2009***

by

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A thesis submitted to the
University of London
for the degree of
DOCTOR OF PHILOSOPHY (Ph.D.)

4th July, 2012

I, Roger Tremayne Miles, hereby declare that the research presented in this thesis is my own original work, except where referenced otherwise.

.....

Roger Tremayne Miles

.....

Date

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Abstract

Even without the pressures of a financial crisis, the Chief Risk Officer (CRO) in UK banks occupied a potentially conflicted role during 2007 – 9. The Boards of banks had created the CRO role with responsibility for managing commercial risk but also for producing public risk reports within a system of enforced self-regulation. Under this system, the regulator seeks to overcome control asymmetries by harnessing the governance resources of regulated organizations. Theoretical perspectives of regulation in action, informal groups in organizations, and individual risk perception, indicated that CROs' dilemmas merited further study. Banks' selective risk reporting practices were under-represented, with scholarly knowledge seemingly limited by difficulties of access and trust. This research overcomes these limitations, gaining access to a closed group to conduct qualitative depth interviews with bank senior managers including 35 CROs (one-third of known incumbents in 2007).

Ideas of enforced self-regulation were found not to account fully for banks' risk reporting practices. The regulator was little-respected, mistrusted, and had limited influence over bankers' behaviour. Within a bank the CRO, though formally identified with risk governance, was informally pressed by powerful sales-side groups to report optimistically. Seeking senior management support to resist this pressure, many CROs instead found their Board prioritising sales activity over risk governance. Though employed as compliance managers, many CROs reinterpreted their role as a commercial support function, becoming coping agents for banks' creative risk reporting.

Enforced self-regulation does not restrain organizations whose reward systems reinforce asymmetries of control, whose economic power exceeds that of governments attempting to regulate them, and whose sales culture aggressively dictates organizational norms. New approaches are suggested to recognise and prevent conduct which increases financial market fragility.

This thesis provides wider lessons for the relationships between organizational behaviour, individual cognition and regulatory power beyond the world of banking.

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PREFACE

The research which follows began in 2006 as an investigation into the way banks behave when responding to regulatory demands. This was to include an investigation into the way that banks' Chief Risk Officers (CROs) appeared to be compromising the findings of their risk tests by presenting unrepresentative information to the regulator. It appeared at that time that the degree and nature of banks' compliance with regulators' demands was significantly under-researched. What soon emerged from CROs' narrated accounts of their experiences was the existence of a more complex range of coping behaviour, producing an unforeseen range of consequences, including a global market crash in 2008.

The research was not intended to predict, let alone find the root cause of, the financial crisis of 2008, whose effects are still being felt today. However, when banking market shocks began to occur during the main field research period (2007 – 9), the research gained topical significance and benefited from vivid new empirical material. Any prescience of topic choice was unintentional – although the findings remain relevant and topical in 2012.

CHAPTER 1: INTRODUCTION

“An act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; it is seen. The other effects emerge only subsequently; they are not seen; we are fortunate if we foresee them. ...The good economist takes into account both the effect that can be seen and those effects that must be foreseen; [he] pursues a great good to come, at the risk of a small present evil.”

Bastiat (1848, p.1)

1.1 Research overview

This research investigates how Chief Risk Officers (CROs) of banks in the UK cope with their regulatory compliance obligations. It also asks whether CROs adopt coping strategies to balance regulators’ demands for compliance reporting against employer banks’ demands for profitable trading. To discover this, original research collects and examines CROs’ narrated accounts of their experiences as they attempt to make sense of these conflicting demands, and identifies coping strategies used as a result. CROs were invited to talk about their relationships with regulatory agency staff, their bank’s sales staff and senior management colleagues. The research reflects on the extent to which all those involved might be described as having engaged in a nuanced version of compliance, and suggests that compliance should be characterised as a scale, rather than a binary choice.

The research enquires into, and locates within existing social studies, the nature of the risk officers’ creative responses to regulators’ demands for information. This topic was already significant before the international banking crash of 2008 and has since become a matter of pressing concern for public policymakers.

Studies conducted in other sectors indicate, as will be seen, that many managers are complicit in enacting coping responses to regulators’ demands, such as interpreting newly-imposed rules in ways which favour continuation of existing behaviour. Until the present study there was no primary research into this phenomenon among senior risk managers in the UK banking sector.

This gap in research knowledge among banks has persisted for several reasons. There are significant obstacles to access to the relevant respondent group: Gaining initial access to, and holding the confidence of, a closed and elite professional subgroup is a particular challenge. In addition to overcoming the sector's cultural exclusivity, it is clearly challenging for an external researcher to ask any senior officer in a high-value business to volunteer information which might be seen as self-incriminating. With a history of confidential contact with senior bankers, this researcher has had access to an otherwise closed group, and has been able to maintain their trust once admitted. This access, and the subsequent support of respondents who entrusted the researcher with sensitive revelations, are distinctive assets of this project.

The working hypothesis has been that we may expect to find among banks in the UK, as already found in other British business sectors, that coping¹ compliance is a common response to a regulator's demands for information. It suggests that, in the banking sector, coping takes a distinctive form: the role creation and deployment of a CRO. It is further suggested that this officer, though charged with responsibility for public reporting of risk, when asked by the regulator for information will in practice act consistently with banks' established coping behaviour – that is, by supporting commercial imperatives.

For similar reasons to the difficulties in obtaining initial access to CROs, one might also predict that there would be resistance to any research attempt to acknowledge or discuss the phenomenon of coping. As well as plainly rational concerns to avoid self-incrimination, this outcome would reflect an established (if tacit) corporate culture of “holding the line”. Given an established professional means of access to the respondent group, the greater research challenge has been to obtain responses with robust validity.

¹ “Coping” is here initially used in the sense of “incomplete” compliance. Concepts of “coping behaviour” are considered in further detail in Chapter 3.

1.2 Research motivation

The research aims to produce an objective review of coping behaviour and strategies among a group which has not previously been studied in this regard. Original findings from a previously little-observed group can be a sound premise for further research with the wider aim of informing a continuing public policy debate around effective regulatory design.

The researcher's previous work in senior Corporate Affairs roles in the financial sector involved, among other tasks, presenting banks' public policy rationales to the government of the day and provided informal access to senior bankers over a more than a decade. In the course of this many anecdotes were heard implying that there were frequent informal trade-offs between a regulator's compliance demand and what response a bank deemed practical. Intriguingly, rules appeared not to be absolute but somehow negotiable; this phenomenon appeared to merit further, structured study.

Having explored academic research in the field, it appeared that the phenomenon of coping² had not previously been studied among banks' senior risk staff. It had, though, been studied among senior managers in other regulated fields, giving rise to a hope that new empirical research might expect to find analogous behaviour among bankers. The present research addresses this shortfall in the literature.

A first step in establishing understanding is to consider fields of research informing the topic. Literatures of relevant fields will be explored in Chapter 3. An initial view of relevant research concerns now follows, starting with an overview of the scholarship of risk, regulation and organizations.

² This term will be further defined and considered in the course of the thesis

1.3 Scholarly interest in Risk regulation and organizational responses

Theories of organizational risk management connect to many different fields of scholarly work: Epistemologies range from mathematics (such as Black and Scholes's [1973] pricing formula) to criminology (Sykes and Matza, 1957). Its academic pioneers include mathematicians (Bernouilli [1738], Bayes [1763]), social anthropologists (Cohen [1970], Marsh and Fox [1992]), social scientists (Perrow, 1984), social psychologists (Kahnemann and Tversky, 1974) and lawyers (Thaler and Sunstein, 2008). Its consumers include corporate boards (Walker, 2009), emergency planners (Cabinet Office, 2002), systems engineers (Kletz, 1993) and product designers (HSE, 2009). From amongst many conceptual strands it was necessary to identify those which could best inform the purpose of this research. The salient fields of scholarship are theories of risk regulatory compliance; of the behaviour of organizations in response to regulators' demands; and of risk perception by the individual (in this case, bank risk officer) trying to overcome uncertainty and conflicts of purpose in a corporate risk management role.

The importance of the interaction between government risk regulation and organizational response cannot be ignored. It is evident in the popular media that risk regulation and organizations' response to it are now prevalent concerns for the British public. A preliminary subject scan of the phrase "risk regulation" sourced across BBC Online's weekly news confirmed this, showing popular news media concern with such topics as: Biotechnology - the urge to rethink GM food bans; estate agents "need regulating" and related Office of Fair Trading crackdown; the call to regulate "unorthodox" (acupuncture and herbal) therapies; Law Commission to consider introducing private claims for consumer compensation; eBay's plan to force Paypal use barred by Australian trade regulator; speculation as to whether the sale of extended warranties will be controlled; police firearms training death as an "extremely rare event" in a heavily regulated setting; rail engineering disruptions for passengers criticised by regulator; water regulator fine depresses utility company profits; voluntary code for advertising of internet access speeds.

These stories are characteristic of a distinct topic of public interest, a news subgenre which might be termed “risk control stories” (Brighton and Foy, 2007). For the news organizations producing them, such stories have the merit of making money by simply adding public outrage or moral panic to pre-existing news analysis (Cohen, 1972; Sandman, 1987; Pidgeon, Kasperson and Slovic, 2003). Regardless of the supply-and-demand mechanisms of news production, the persistence of news headlines about risk control supports a research starting-point that the control of risk is now a routine concern for the British citizen. A large body of academic work substantiates the point that civil society regards risk as a significant topic – especially its perception, dynamics, and regulation – with far-reaching impacts on multiple areas of society and public policy design (e.g. Douglas, 1986; Beck, 1999; Slovic, 1993). As news headlines suggest, the topic of linkage between regulation and human behaviour continues to interest the popular media.

The following research considers impacts on UK bankers of a trend in British public perception of risk. Public anger at bankers following the 2007 - 8 credit crisis adds a topical edge to the more longstanding concerns addressed by this research. As first conceived in 2005, this research proposed to explore the phenomenon that bankers appear to adopt a compromising attitude towards regulators. The events of 2007 - 8 sharply raised public and political concern around this point.

Whilst there is much discussion of the notion that business interests tend to deflect attempted regulation (Kagan and Scholz, 1984; Braithwaite, 1982; Black and Rouch, 2008), before 2008 there appears to have been little direct questioning of UK-based deposit taking bankers themselves on the subject. A hint of bankers’ collective attitude may occasionally be glimpsed, for example in this passage from a banking sector newsletter at the height of the credit crisis:

“Complying with [FSA] rules is a science and occasionally an art. ...A good relationship with supervisory contacts can have a positive impact [and] can often tilt the balance away from enforcement action. Given its limited resources, the FSA usually prefers to conclude swiftly. ...The FSA brings enforcement action based on high-level principles... so there may be room for debate about what conduct warrants a penalty and what is simply failure to achieve perfection or ‘best practice’. Remember also that the Tribunal [regulatory decision review body] has made applicant-friendly decisions in the recent past. Take comfort that UK fines are rare and usually small.” (Morris and Shanahan, 2008)

The seemingly general acceptance of the regulator’s “light-touch” approach (interpreted in practice by many regulatees as “laissez-faire” or even “hands off”) suggested the merit of research along the lines of: Does such behaviour reflect a belief within the industry that the regulator has been suppressed? – perhaps by “regulatory capture” (Ayres and Braithwaite, 1992), or other means? Are practitioners careless of the penalties? Or is the relationship between regulator and regulatee more complicated?

The remainder of this chapter will begin to expand on these initial questions. Bankers’ behaviour may be better understood in the context of the sector’s history of risk governance; Chapter 2 will consider this history, including the emergence of the CRO, before the thesis continues in a conventional structure (see 1.6 below).

1.4 Why research compliance?

Academic research suggests that managers in various regulated sectors may be tempted to decide for themselves whether or not to comply with any given rule, depending on whether they think the rule suits their own purposes. Studies of managers around the world and in a number of sectors have identified a common range of coping responses that may arise when a regulator intervenes in their work. Previously researched sectors include food retail (Fairman and Yapp, 2005), medical care (Bevan and Hood, 2005), pharmaceutical research (McGoey, 2007), maritime safety (Gunningham, 2009), and consumer financial services (Broadbent, Jacobs and Laughlin, 2001). Observed responses typically range

from patient or impatient acceptance, through tacit disregard, to subversion, or other forms of defiance, even (rarely) including expressions of open hostility.

The study field of organizational behaviour in response to regulation – “compliance culture” – is still emergent and suggests fertile ground for research initiatives. Recent research (Hood [2002]; Fairman and Yapp [2005]; Hutter [2001]; Kodate and Dodds [2009]) has suggested the notion of cognitive framing by which regulated individuals conceive compliance. These research findings are thematically linked in that they observe that compliance and non-compliance should not be regarded as binary opposites: Rather, as can be observed, a regulated person’s behaviour lies somewhere along a continuum “scale of intent to comply”, with exact position along the scale varying over time in response to new experiences, revised risk information, and changing perceptions. Factors which influence a given actor’s position on this scale may include how fair or relevant a new rule appears to be; how the regulator’s staff behave; how (or if) an employer signals that compliance is expected; and how much informal group pressure there is to obey or ignore controls.

If compliance should be reconceived as a model “scale of intent”, as distinct from a binary indicator (either compliant or non-compliant), this calls into question certain conventional assumptions about how regulation operates in the real world. A view of the regulatory domain as a negotiating space also raises questions about the extent to which apparent compliance is the same as real compliance, and whether either of these states has any meaning in a sector where regulation has been seen to fail.

Even without the topical backdrop of a crisis of public confidence – as with banking regulation following the credit crunch – we might expect recent research insights into behaviour to present a good opportunity to challenge certain assumptions made by policymakers about regulatory efficacy. There are two prime focuses for this challenge. The first is one described here as the “Newtonian assumption”: This is the rationalist premise that regulated actors “know what’s good for them” and so may be expected to self-correct deviant behaviour after new regulations are imposed. Those who draft new regulation

expecting a rational response, and good conduct, rely upon this assumption. The second assumption regards over-reliance on indicator systems and implicitly the devaluing of personal and empirical experience of risk-taking. This may be described as the “models assumption”. In the UK banking sector, it refers to regulators’ belief – or hope – that control systems are effective as long as they are well-populated by market-derived risk models. By March 2009 the regulator admitted to a “misplaced reliance on sophisticated maths to manage risks” (Turner, 2009).

Recent bank failures beg research questions which challenge these assumptions. Before considering how research might address this, it is useful to reflect on the obstacles which face any attempt to regulate modern banking.

1.5 Why is banking hard to regulate?

As this subsection will consider, the business of banking presents unique and complex challenges to designers of regulation. As a result the sector is inherently attractive to students of regulatory design. Nor is this just a matter of academic interest. A reliable commercial banking system is of critical importance: enabling world trade, supporting nations’ economic stability, and handling cash as a utility service to citizens. Yet as modern banking services have evolved, various factors have begun to make banks increasingly hard to regulate. These are now examined.

Firstly, there is asymmetry of knowledge between providers – in this case, banks – and purchasers (and indeed the wider community). Banking products are complex and largely virtual; that is, intangible. Complex contracts may be unintelligible even to the bank staff who market them, let alone any agency tasked with supervising them. Allied to this is the use of complex mathematical and monetised models of risk to calibrate regulatory standards, even though these models are unilaterally assembled by banks’ risk specialists. No matter how complex the maths, such econometric models do not represent, or support, direct control of social interactions such as operation of cultures or behaviour.

Secondly, there is fragmentation between various banking activities and the regulatory frameworks that seek to control them. Banking business tends to consist of many, typically diffuse, elements whose control regimes follow disconnected regulatory standards. These standards tend to have originated in distinct fields of professional practice such as audit, actuarial, fund management, treasury accounting, securities trading, share ownership, and consumer debt protection. The drivers of these various regulatory standards reflect their variety of origins, in professions with diverse aims such as: Fair statement of value; objective assessment of risk in markets, credit or contracts; transparency; or good governance. Moreover, many banking activities are simply not regulated: The US Federal Reserve's admission in 2010 that the hedge fund or "shadow banking" (unregulated products) market may be twice the size of the regulated market is a chilling reminder of the scale of the regulator's ignorance of trading activities (Pozsar, Tobias, Ashcraft and Boesky, 2010).

Thirdly, although they often trade separately from one another, banking markets are to a great extent interdependent, deciding commodity values on the basis of other markets' perceptions of value. Although commercial operating units may be fragmented, many elements of trading are close-coupled; that is, each element's performance may depend strongly on what other elements are doing. Interdependencies exist between products, institutions, and national and international markets. Two notable risks produced by this linkage are contagion (the tendency of one market or nation to respond adversely to neighbouring events, whether this response is rational or not); and offshoring (the perverse incentive to contract for risks across or beyond national boundaries). These risks in banking occur beyond the jurisdictional reach of nation-state regulators.

Fourthly, the banking sector has a dominant presence in some nations' economies, notably the US and UK. Other business sectors, and the public sector, are affected by this asymmetry of economic power. In a bank which has greater economic power than the nation-state which hosts its offices, sales staff may be willing to exploit this dominance to resist local regulators' attempts at control. Economic asymmetry may therefore produce asymmetry of public

control, or regulatory capture (Bernstein, 1955; Ayres and Braithwaite, 1992); the observed tendency of a dominant sector to exert control over public policy and regulatory agendas. As a business largely selling virtualised products, a bank facing regulatory changes can threaten to move its business base away to a new jurisdiction, out of a host country, so removing tax revenues and earnings streams from that country. Similarly, banks are aware of their own corporate longevity; they may exploit this to engage robustly with the government of the day and to dismiss short-term policy initiatives, knowing that the bank will far outlast the tenure of any minister or government.

Fifthly, the regulator's lack of resources is also an issue: the volumes and complexity of banking transactions are simply too great to be capable of thorough supervision; hence the appeal of a system of enforced self-regulation as a way to overcome the regulator's resource shortfall.

Sixthly, in the absence of concerted public advocacy to challenge the sector, a regulator may not expect to receive popular support; this may further encourage regulated practitioners to defy attempts at control (Ayres and Braithwaite's [1992] "counter-capture"). Again despite the clear social consequences of a credit crunch, it has remained difficult for the lay public to connect the damage caused by "big finance" to intelligible sources of blame. Although the UK's Financial Services Authority (FSA) was tasked with protecting the public interest, and although banks were held in low public esteem even before the 2008 crisis, to date there has been no successful attempt to harness hostile public opinion against the industry over the long term (compared with, for example, the founding of the Consumers Association to combat the sale of unsafe goods in the 1960s). As nascent protest groups may have found, it is hard to define, locate, or draw attention to "toxic financial waste sites" in the virtual-product landscape of banking. Compared with, for example, the empirically detectable trails of environmental damage left behind by conventional heavy industries, banking catastrophes merely leave protestors chasing intangible abstractions. Less than two years after a collapse of global banking markets, an environmental catastrophe associated with BP in the Gulf of Mexico raised a wave of public outrage more visceral than any protest directed at the banks, even though the

economic damage to BP, at 50 billion US dollars, was a fraction of the sums required for taxpayer-funded bailouts of individual US or UK banks.

For all the reasons stated above, it can be seen that banking is a difficult sector to regulate. For many academic analysts, a rational response to such challenges is to invoke enforced self-regulation, which holds out the promise of control by pressing the industry's own reporting systems into the service of the regulator. Even after the onset of the latest banking crisis, policymakers continued for some months to advocate the banks' own argument that reporting responsibility is best left to expert practitioners. More than three years later, the extent of failure of a regime of enforced self-regulation – which banks had enthusiastically supported – is becoming clearer, yet the improvement made by proposed new regulation is also hard to qualify. The UK regulator has only recently started to refer to a “conduct risk” approach (FSA [2011, 2012]), which seeks to control behaviour by direct observation, as opposed to regulating by econometrics or product design; a focus which public interests would appear to welcome.

A banking regulator faces a particularly acute problem of practical engagement with regulated businesses. Although a policy of enforced self-regulation carries good intentions, the operational realities of banking impose unique burdens on any regulator seeking to apply them in practice. Banks deploy complex instruments and processes; the volumes of transactions they generate, and the associated data, are far too large to be fully overseen; whether monetary or event-triggered, the value-component of some contracts tests the limits of human comprehension; and the commodity being traded is, for all practical purposes, virtual. A limited number of supervisors, often lacking expert knowledge, face the prospect of engaging with all of this in a high-speed trading environment where access to time with business principals is limited and where interruptions by outsiders (especially “cost centre types”) are unwelcome.

Commercial practitioners do recognise that enforced self-regulation is a plausible approach for a regulator to adopt to try to manage such difficulties. A new regulator such as the FSA (in 1997), faced with massive asymmetries of information, quantity and quality of staff, may feel more or less compelled to

enlist the resources of the industry it supervises. To deflect the criticism that this strategy is really no more than co-optation, and to attempt to create a deterrent effect, the regulator may also punctuate routine monitoring with a few acts of symbolic enforcement, such as heavy fines or highly-publicised arrests of practitioners suspected of misconduct.

1.6 Overview of structure

Regulation of banking is a topic deserving close study, this thesis suggests, not so much because of one recent market shock but because of the continuing difficulty facing regulatory policymakers who wish to overcome the above-mentioned problems of control design. Add to these problems a trading context which – at least until the 2008 shock – allowed banks considerable leeway in the reporting of risk; a lack of concerted public challenge to this, with widespread ignorance of data manipulation and risks taken, and the subject becomes a compelling focus for original research. The remainder of this thesis will address the topic with the following structure:

In Chapter 2, banks' development of risk management, relationships with the regulator, and the Chief Risk Officer function are considered. Attention is drawn to the origins of a situation in which the banking sector came to present strong and unique challenges for regulators.

Chapter 3 then explores relevant previous research informing the development of present research questions, identifying the value of conducting original research to make good an apparent shortfall in the knowledge base. In Chapter 4, methodology is advanced for a detailed study to test the contention that, at least until the events of 2008, banks' risk officers regarded coping as a normal and acceptable response to regulatory demands imposed on their sector.

Chapters 5 to 7 present the resulting original field research, considering whether the new evidence supports a contention that bankers' notions of compliance may include factors not previously noted in studies of coping. A research contention unique to the present project and sector is that the creation of the new

management role of CRO literally embodies, in human form, an extension of banks' long term strategy of deploying coping responses to the regulator's compliance demands.

Chapter 8 concludes by bringing the findings together. Besides improved understanding of coping phenomena in a new sector context, findings suggest new forms of action which regulators and market participants might wish to take to counter any tendencies to coping behaviour. After presenting conclusions, the chapter also suggests directions for possible future research. Along the way, the research findings will be seen to indicate where there are analogies to be drawn between banking and other sectors where complex conceptions of compliance, and resulting deviations from good conduct, have already been identified.

CHAPTER 2: THE RESEARCH CONTEXT

2.1 Introduction: UK banking industry context for the emergence of the Chief Risk Officer

Chapter 1 introduced the topic of this research and argued that it merits new study: UK bank Chief Risk Officers' (CROs) experiences of noncompliant responses to regulators' requests for information. The research will focus on gathering by interview, and reviewing, primary accounts of coping responses. Its aim is to improve scholarly understanding of banks' noncompliant response to a regulator's demands for risk reporting; a form of behaviour now regarded as a potentially significant factor in the banking market shocks of 2008 (Walker, 2009; Wolf, 2009; Tett, 2010; Turner, 2009b, Lewis, 2010).

Before considering relevant research studies in Chapter 3, and developing a detailed methodology for original research in Chapter 4, this chapter will reflect on the regulatory circumstances of the UK banking sector in 2008, to place interviewees' perceptions in their topical context. Because UK banks have been criticised for enjoying special privileges (Black and Rouch, 2008), some knowledge of banks' antecedent relationship with regulators assists understanding of why public controls did not prevent bankers' excessive risk-taking, and compromised reporting of risk, to be investigated later in this thesis. The CRO role, created in part in response to the regulator's concerns in the early 2000s, is central to this understanding and to the research which can develop understanding further. As will be seen, the role may be conceived as representing – even embodying – certain organizational coping strategies, which are also to be considered in the research which follows.

Between the deregulation of 1986 and the advent of the Financial Services Authority from 1997, regulation in UK financial markets co-evolved alongside the markets themselves. Markets had a cultural history of vigorous, resilient and fast-innovating commercial practice (Knafo, 2008; Roberts, 2004; Christophers, 2012). This research is concerned with exploring whether that tradition may have continued, however tacitly, to inform modern banking practice and how

regulators now interact with bankers who may invoke it. The current chapter summarising regulatory development is intended only to point to significant differences in the way that financial markets and governments characterise risk. Having set public risk management concerns within this context in Chapter 2, the thesis progresses conventionally from Chapter 3, moving to consider relevant theory and unanswered questions.

Chapter 2 therefore now considers factors shaping the culture of risk management in UK banks, including developments in regulation. This culture may be expected to inform bankers' routine activities, commercial decisions, and interactions with regulators. Chapter 2 also outlines the role and powers of a CRO as conceived by the regulator; banks' conceptions of the role may be revealed subsequently in new research.

2.2 Changing dynamics of risk management and regulation in UK banks

Any study of banks' interactions with a regulator might benefit from first noting the context of how the current regulatory regime came to exist, shaping bankers' interactions with regulators. This section will identify the regulatory system prevailing in 2008, and its antecedents, as these informed banks' culture of commercial practice and regulatory compliance.

2.2.1 Early developments, to 1986

London banks have a history of self-confidence which is partly due to their historical good fortune of being located in a major hub for international commodities trading. Through the 17th and 18th centuries, Britain enjoyed effective control of many overseas trading opportunities, with London as a centre for easy maritime access to the Baltic, the Mediterranean and the Atlantic, and exporting from a booming domestic manufacturing base (Black, 1989). In the same period, wars in continental Europe encouraged commercially active migrants to move their trading operations to London as a safe haven, devising "new techniques of financing" to integrate with England's self-interested

banking community (Knafo, 2008). By the time London had become the world's busiest port, in 1700 (Roberts, 2004), dedicated merchant banks had evolved to finance overseas trade. Through the 19th century the City massively developed its capacity for market-making, to capitalize the ever-larger projects emerging from the industrial revolution: new manufacturing technologies; new national infrastructures, such as rail transport and supply utilities, in the UK and around the world; and even the national ("sovereign") debts of other countries.

Initially protected only by early commercial law, and reliance on a strong tradition of oral contract-making ("my word is my bond") (Knafo, 2008), market participants regarded the possibility of a bank failing as a normal hazard of commerce (Mackay 1841/1996; Kindleberger, 1978/2000). As a new science of risk management began to develop, commercial operators began to question the inevitability of certain types of loss, devising financial and practical loss-prevention measures such as insurance (Bernstein, 1996). Nevertheless, collapse of a bank continued to be seen as unpreventable (Kindleberger, 1978/2000), until in 1890 a major shock passed the Bank of England³ *de facto* responsibility for supervising risk: The Barings crisis.

Barings Bank found itself credit-squeezed in 1890 and its Directors begged the Governor of the Bank of England to "do something, or say something, to relieve people's minds [because] they have made up their minds that something awful is up" (Kindleberger, 1978, p.152). The Bank of England stepped in as "lender of last resort", carrying Barings' commercial risk and helping to assemble a syndicate of other banks to fund a rescue and avert systemic collapse.

Other shocks, such as the recession following the collapse of confidence in stock markets in the 1930s, were also popularly blamed on speculative financial markets, and central banks' failures of supervision (Roberts, 2004). Yet until as late as 1979, each practitioner group within the UK financial market – including

³ Originally a government agency for marketing war bonds, the Bank of England evolved to become an official handler of government debt, and so regarded as the City's senior banking institution

bankers, accountants, insurers, and share traders – continued to self-govern, designing rules to protect their own commercial interests and continuity.

2.2.2 Two major changes of regulatory approach in the UK financial sector, 1986 - 2008

It is significant for banks' relationships with their regulator that since 1986 they have been subject to two fundamental changes in regulatory policy. Both of these new policy initiatives have given bankers regulatory controls based on self-reporting. Both regulatory systems thus offered opportunities for bankers to engage in creative compliance – that is, the manipulation and exploiting of the “spaces between” formally presented rules to circumvent any controls which might disturb commercial market-making (McBarnet and Whelan, 2011). Before the market shocks of 2008 many financial market practitioners had regarded the previous twenty years of credit-driven growth as the natural and benign outcome of these two public policy stimuli.

The first of these policy initiatives was the Conservative government's wholesale market deregulation of 1986, which permitted banks to trade in commercial debt, diversify trading activities and reduce their capital constraints. This “big bang” (as the Financial Services Act 1986 was popularly known) also relaxed the rules on cross-ownership between different types of financial institution. The 1986 initiative encouraged rapid agglomeration of financial trading entities into multi-service financial groups, blurring public perception of the distinctions between various activities such as retail and commercial banking, insurance and securities trading, such that a failure of any one type of business might raise questions about quality of controls in the sector as a whole (Walker, 2010).

Secondly, in 1997 an incoming Labour government created a new independent regulator, the Financial Services Authority (FSA), in part in response to popular perceptions that since 1986 the financial sector's system of a voluntary Self Regulating Organization (SRO) for each financial market had failed to prevent abuses (Walker, 2010). In place of SROs, the FSA introduced a system of enforced self-regulation, a control mechanism advocated by Braithwaite (1982),

which required businesses to bring to their own resources to bear on informing rule-making, risk reporting and compliance, under threat of formal prosecution for non-compliance. HM Government gave the FSA a broad remit, including statutory objectives to oversee wholesale and retail financial market standards; to support orderly markets and public confidence; and to prosecute rule-breakers (FSA, 1997). In spite of these powers, practical achieving of fully compliant behaviour might be expected to prove elusive, as the present study will explore.

The FSA had been founded on an earnest intention, following loss of public trust in the 1986 self-regulatory system, as will now be considered.

The FSA replaced former subsector self-regulators in securities, banking, mutual savings, fund management, consumer saving and paper trading (shares and derivatives). The FSA was also subsequently tasked with preventing market abuse, and with supervising mortgages, general insurance, and dispute mediation (ombudsman schemes). Its creation followed on from two notable control failures. The first of these was the biggest bank fraud in history, at the Bank of Credit and Commerce International in London in 1991, which had raised questions about the adequacy of the City's supervision in general and the role of the Bank of England in particular: The Bank of England, and by extension the City's whole regulatory apparatus, appeared to have wished to maintain market-making whatever the ethical cost, and hence seemed more interested in self-preservation than in effective intervention (Roberts, 2004). Had a culture of "holding the line" (or its dark side, "co-optation" or "regulatory capture") become normalised?:

"These episodes fostered a perception among some sections of the public and politicians that fraud and wrongdoing were commonplace in the City and that the Bank of England was not up to the job."

(Roberts, 2004, p55)

The Banking Act 1987 had provided a new framework for prudential control, in the form of Value-at-Risk ⁴ (VaR) risk measurements. Yet practical

⁴ This factor is defined and expanded upon in section 2.2.5 below.

implementation of the 1987 Act was found to be not robust enough to prevent the onset of the second major control failure, and most expensive bank collapse then recorded, the failure of Barings, in 1995⁵.

Although the FSA was given statutory powers from the Financial Services and Markets Act 2000, its governance structure is a company limited by guarantee and financed by the financial services industry. It is an independent non-governmental body funded entirely by the firms it regulates and provides open information for firms, consumers and others about its objectives, plans, policies and rules; and about consumer financial products, regulation and rights.

Whilst the FSA was conceived as an overarching regulator for the conduct of business by financial services practitioners, it does not oversee certain core aspects of commercial banking activity, which are subject to continuing debate after the 2008 credit crisis drew attention to overlapping control regimes.

A complicating element post-1997 was the presence of two other institutions in the banking regulatory framework: The Bank of England and HM Treasury. The resulting tripartite structure was regarded by some bankers as multiplying their opportunity to exploit loopholes in the control system (see section 2.2.3 below). Although the FSA was the primary regulator, responsible for general day-to-day conduct of business and the licensing of practitioners, HM Treasury retained a theoretical right to intervene in the national economic interest, whilst the Bank of England was charged with overseeing systemic risk and maintaining markets' stability.

Banks were subject to other regulatory oversight (detailed in 2.2.3), including limits on commercial risk-taking. These were formulated under the Basel capital adequacy rules set by a global committee of central bankers and supervised in each country by the lead regulator (the FSA and the Bank of England, together, in the UK). As is now clear, the Basel rules did not anticipate or prevent the 2008 liquidity crisis. The FSA was also the local (UK) regulatory agency

⁵ See Annex 4 for case notes describing this and other significant events of control failure

supervising EU-wide rules on financial product marketing and transparency, with four statutory obligations relating to this: To maintain market confidence; to publish information transparently; to protect consumers; and to reduce financial crime.

The creation of the FSA is one example of a long-term readjustment in understanding between regulated commercial sectors and government, a “broader political and cultural change” around the public and commercial governance of risk (Hood, Rothstein and Baldwin, 2001). In parallel with changes in regulatory regime, the commercial understanding and definition of risk evolved significantly during the 1990s, and this development is separately considered in section 2.2.4.

2.2.3 The FSA’s role and its connections to other regulators

As the current research will consider the role of the Chief Risk Officer in responding to regulators, to support this purpose at this point it may be helpful to highlight key elements of the banking regulatory regime in force at the time of the present field research (2006 – 9), and thus the object of the CROs’ perceptions as reported in Chapters 5 to 7.

Although the FSA is the principal regulator for intra-UK banking activity, three bodies share responsibility for oversight (“Tripartite” supervision), each with its own focus of concern: HM Treasury (for the national economic interest); the Bank of England (overseeing systemic stability); and the FSA (granting commercial licenses to operate, dependent on good conduct). The FSA’s supervisory stance is reviewed from time to time but at the time of the present fieldwork was held to be “comply or explain”, supporting a “light-touch” or “principles-based” approach to intervention, as opposed to a technocratic, tick-box or “zero-tolerance” approach (all phrases FSA, 2006). The development of regulatory practice towards this point is considered in greater detail under the literature review in Chapter 3.

The FSA also applies EC-defined standards regulating acceptable conduct of business. These govern the marketing and transparency of banking products and include requirements for clear product explanations and reporting of transactions. Following the allowance for a period of adjustment under the EC's Financial Services Action Plan (1995 – 2005), in 2007 banks became subject to the EC rules, known as the Markets in Financial Instruments Directive ("MiFID").

Banks' solvency – and hence ability to conduct lending business – was also specified by a supranational treaty between commercial- and central- bank actors: the Basel Accord ("Basel II" 2005 to 2010, "Basel III" from 2011). This treaty specifies controls on operational risk and on capital adequacy. Sponsored by central banks of the G10 nations and with more than 100 signatory nations globally, the Basel framework requires each bank to apply and report consistent standards in assessing risk and managing decision-making. Basel provides standards for regulatory capital and guidelines on economic capital, binding signatory countries' banks to oversight of "prudential capital adequacy" by the Basel Committee on Banking Supervision, convening at the Bank for International Settlements, in Switzerland.

Various regulatory agencies specify certain other standards of acceptable performance in other aspects of business. London-originated deals connecting into other national markets have to comply with the requirements of local regulators in those markets (such as the US Securities and Exchange Commission [SEC]). The publication of financial accounts, and audit scrutiny standards for these, has UK standards and has been the subject of an extensive international debate towards a transnational Reporting Standard, though this too remains elusive at time of writing. For crime prevention, in addition to respecting criminal and commercial laws in national jurisdictions, banks subscribe to global standards agreed through the Financial Action Task Force on Money Laundering, which seek to avert the risk of banks handling (whether knowing or innocently) the cash proceeds of criminal activities.

2.2.4 Loss of public confidence in risk controls: Financial market shocks and perceived failures of regulation

Financial market shocks occurring during the course of this research have raised public awareness of banking risk. Public debate has focused on appropriate risk management in general and, in particular, raised questions about the perceived shortcomings of operational risk controls. Bankers participating in the present research might therefore be expected to show a reflexive appreciation of public concerns about regulation.

Then again, it is possible that bankers may be unconcerned about any of this. One professional journal has identified a lack of empathy with the public as a common characteristic among bankers and financial regulators alike:

“As far as the Bank of England was concerned, there was no logical reason why Northern Rock depositors should ask for their money back. ...Yet withdraw they did, forming queues outside branches across the country. ...[The Bank of England] decided to stay tight-lipped... [then the] Chancellor of the Exchequer appeared on television and told everyone to calm down and be sensible. Much to everyone’s surprise, his intervention had the opposite effect, and only heightened the sense of panic. ...Telling worried people to stop worrying tends not to work, especially when the person issuing the instructions is an authority figure in a suit.”

(Baker, 2007)

On the evidence of Northern Rock savers’ experience alone, the threatened collapse of a bank has a profound effect on public confidence. Even before the Northern Rock collapse, a number of other factors were adversely affecting public trust in regulation in general, and financial regulation in particular. These factors are now considered, before returning to the impact of Northern Rock’s problems.

As reported widely in the news media, and subsequently confirmed through academic research and official public enquiries, performance targets in certain regulated sectors have been seen to be abused by regulatees’ “gaming” responses. This phenomenon has since produced a significant subset within the

literature of regulatory studies. Recent reports have noted the phenomenon of “gaming” responses in fields including healthcare (Hood, 2002; Kodate, 2009), shipping (Bloor and Samson, 2007), policing (Williams, 2008), public transport (Hutter, 2005) and high street banking (Parker and Nielsen, 2011). A common conclusion is that regulators tend to overclaim their own efficacy. These and other academic contributions to the public debate are considered further in Chapter 3.

Shortly before the market shocks of 2007 - 8, there had also already been a marked loss of public confidence in financial fraud prosecutions, as evidenced by a report presented to HM Government by the Fraud Advisory Panel (2006). The report was compiled by a group of senior UK public- and private- sector lawyers and auditors, aggregating their collective experience and formally raising concern that regulatory structures were insufficient to prosecute serious fraud with any success:

“The public no longer believes that the legal system... is capable of bringing the perpetrators of serious frauds... effectively to book. The overwhelming weight of evidence laid before us suggests that the public is right.”

(Fraud Advisory Panel, 2006)

Citing the collapse of the Jubilee Line corruption trial in March 2005 (a case in which the actions of banking advisors were held to be a significant factor) at a cost to the public purse of £60m, the Fraud Advisory Panel pointed out an urgent need to restore public trust in the efficacy of regulatory process.

The Fraud Advisory Panel’s concerns were also supported by academic analysis of the systemic inability of policymakers and of the executive arms of the Law (police and public prosecutors) to achieve any cultural engagement with financial practitioners (as predicted by Kagan and Scholtz [1984]). Reviewing cases studied in North America, the UK and Australia, Williams (2008) aggregated law enforcement officers’ concerns that financial criminals

“appear to have nothing to fear... The perception [of enforcers] is one of ‘invisibility’. This is the result of interrelated factors: complexity of the cases; procedural delays; mandated [prosecution] disclosure obligations; evidentiary challenges⁶”

(Williams, 2008, p310)

Williams’s concerns were added to a wider debate about the perceived inability of regulators to counteract corporate crime in the face of globalization and the resulting blurring of jurisdictions. This research theme had been pioneered by Tombs, who together with Pearce [1990] and Whyte [2003], had warned early of the socially corrosive effects of “regime shopping” by multinationals. This theme is of interest to the current research, where bank risk officers may be expected to recognise some of Tombs’s objects of concern, albeit in sector-specific forms such as (in the traders’ own jargon) “jurisdiction-hopping”, “offshoring” and “grey banking” as strategies to avoid regulatory control. These phenomena merit further questioning (see Chapter 5).

Public concern also focused on the inherent weakness of the divided, tripartite regulatory control agency operating from 1997, involving the FSA, the Bank of England and HM Treasury. The remainder of this subsection considers market abuses and certain specific incapacities which public concern identified in the regulator, failing to prevent abuses. Bankers’ responses to the FSA, as lead regulator, are to be the present focus; it is relevant however to note that control lapses have historically occurred, and seemingly continue to occur⁷, whichever regulatory agency is in office. Banks’ risk officers might be expected to have interesting views on the issue of the generic failures of regulation, from inside the organizations which run the regulated risks.

The UK banking market is vigorous, accounting for nearly 10% of the United Kingdom’s GDP (Haldane/Bank of England, 2010). This economic strength has allowed banks, at least until recent events, to demand and expect to receive

⁶ Williams (2008) cites as examples: “the inability to compel witnesses to respond to enquiries, and the need to derive criminal intent from activities (e.g. trading shares) that are patently legal”

⁷ Such as, at time of writing: JPMorgan’s inadvertent loss of £1.2bn in UK derivatives trading: *JP Morgan boss admits failures* BBC News online, 13th May 2012; Barclays traders manipulated market risk reports: *Barclays fined for attempts to manipulate LIBOR rates*, BBC News online, 27th June 2012

minimal interference from regulators. Over time, in some bankers' minds, this may have developed into a sense of entitlement to non-intervention, or even of immunity. One might therefore wish to ask UK bankers whether they regard themselves as natural survivors, or deserving special protection. Is banks' continued survival perhaps due to their own development of coping strategies, which have enabled them to endure major shocks to market operations and confidence? It is useful to consider initially here how banks have come to survive, before addressing through original research any sense of entitlement which bankers may have come to develop, perhaps partly as result of their state-protected survival through the market shocks of recent years.

These shocks include failures of providers in every category of regulated business. In the past quarter-century alone, every UK financial service subsector has produced its own costly control failures and it is a natural topic for research to invite bank risk officers to discuss their perceptions of any lessons from these events. Detailed in Annex 4, these include collapses in the following commercial activities: commercial banking (Crocker, BCCI); investment banking (Barlow Clowes, Morgan Grenfell); securities trading (Merrill Lynch, County NatWest); money broking (British & Commonwealth Holdings); traditional deposit-holding (Barings' self-destructive venture into derivatives in the early 1990s); mortgage banking (Northern Rock, Bradford and Bingley, Halifax, TSB); commodities trading (Johnson Matthey); pension fund management (Mirror Group Trustees); insurance (Equitable Life); hedge fund management (also known as "shadow banking") (Long Term Capital Management); securities broking (NatWest Markets); and corporate value reporting (Arthur Andersen). These are, generally, failures of business-to-business operation; meanwhile the mis-selling of financial products to consumers on the high street has continued, with sales frauds perpetrated through products including endowments, mortgages, pensions, life assurance, credit insurance and annuities.

One event in particular, however, the collapse of UK regional mortgage bank Northern Rock in 2007, came to be popularly regarded as marking the onset of a fundamental crisis of legitimacy for regulation, and even for government:

“a catastrophe... obliteration of the Prime Minister’s credibility ...derogation of power... if this kind of [public] money is available for a minor bank in Newcastle, what else could the Treasury have done with £55 billion?”

(*The Times*, leader column, 22nd January 2008)

Following the Northern Rock collapse, commercial bankers also thought to question why regulators had previously insisted that their preferred method of control, a capital adequacy standard, might be sufficient to keep the banking system stable. Bankers noted similarities between the Northern Rock crisis and the collapse, two years earlier, of the Long Term Capital Management hedge fund (LTCM), whose “unprecedented” levels of arbitrage had combined with a “blind faith” in risk models to create a “disastrous downside” (Mackenzie, 2006). Regulators were seen to have substituted warnings for effective intervention, to have been communicating instrumentally

“to give regulators the evidence to say ‘We told you so’ in the event that the horse bolts, rather than to chivvy recalcitrant bankers into locking the stable door in the first place.”

(Pearce and Tombs, 1990)

Failures of more major banks during 2007 – 8 pointed to a specific regulatory blind-spot: Uncontrolled liquidity. In the public mind, bank failures revived earlier latent concerns about certain unresolved problems inherent in banking regulation. Prime concerns included moral hazard, diffusion of control responsibility, and inappropriate focus of control. Each is briefly noted here, together with a contemporary public expression of the concern.

Firstly, public concern focused on *moral hazard* – that is, that publicly funded bailouts of failing banks may be expected to increase, rather than decrease, bankers’ risk-taking. It is tempting for governments to seek to support public confidence by propping up failing banks with public funding. However, the state’s issue of a guarantee for one bank may encourage other banks to be more reckless, as commentary in *The Economist* noted at the time of the second wave of credit shocks in 2008:

“banks feel free to lend recklessly [if they know] the state will limit their downside risk. ...nationalisation of the downside of extreme financial risk may potentially prove far more of a disaster than [the] decision to nationalise Northern Rock.”

(*The Economist*, 19th February 2008)

Secondly, the recent wave of bank failures, from Northern Rock (2007) onwards, led to public questioning of how clear the regulator’s *control brief* was. Even under normal trading conditions, it could be hard to discern which of three interested bodies (FSA, HM Treasury, Bank of England) should be taking lead responsibility for maintaining public confidence. Public concern was that, with the onset of the credit crisis

“...no one [of the three] takes charge, no one takes the tough decisions and everyone is too interested in shifting responsibility and blame... a very disappointing game of bureaucratic pass-the-parcel, [it] urgently needs reform.”

(*The Times*, 7th November 2007)

Thirdly, there was concern that the regulator’s *focus of control* – that is, the tools used and their point of application – was inappropriate. In 2008, regulatory controls had focused on capital adequacy but neglected to provide for liquidity risk, the factor which destroyed Northern Rock, LTCM, and the Scottish retail banks. Worse, among a new generation of virtualised or derivative financial products (“vehicles”), some had been designed to avoid regulatory control, so that

“banks have been able to lend more without increasing the amount of capital required. These vehicles ran a clear funding risk: If ever the money markets became illiquid they would be unable to repay.”

(*Prospect*, February 2008)

Contemporary news reports, as above, implied that the Northern Rock collapse may have signaled an end to an unspoken public tolerance for financial service providers: formerly, it may have been acceptable sometimes to ignore rules, as long as there was some benefit and nobody was hurt by this. Some have suggested that Northern Rock might in theory have survived if the BBC had not

broadcast the bank's liquidity problems to the public (see discussion in Annex 4) – yet in reality, public risk perception of a “failing” institution tends to confirm the failure as a fact, as evidenced by the queues of depositors waiting to withdraw their cash. Northern Rock savers were not concerned whether an institution had been in technical breach of borrowing covenants; they just wanted to lay hands on their own money. In this case it is the actions of the general public that pass judgement on corporate conduct as unacceptable:

“The point is that the response of other people has to be regarded as problematic. Just because one has committed an infraction of a rule does not mean that others will respond as though this has happened. ...Formal rules ...may differ from those actually thought appropriate by most people.”

(Becker, 1963, pp 12, 16)

Control failures arouse public concern, and with this, often calls for regulatory action. The 2008 liquidity crisis and public-funded bank bail-outs drew criticism of the FSA's discretionary “light touch” approach; of banks' self-reporting of risk; and, as in the Halifax fraud case, of the impact of ephemeral contacts with individual case officers. These factors will be explored here (see Chapters 5 and 6). The event of collapses and frauds was seen to indicate that the regulatory apparatus itself had introduced risk into the system – an unwelcome secondary risk. The FSA's intention, under risk-based regulation, had been to compel banks to make their commercial risk assumptions explicit. Instead, but condoned by the FSA, banks handed off responsibility for risk governance by giving the task to a newly-created senior management role, the Chief Risk Officer (CRO). The evolution and scope of this role, and experiences of those who hold it, appear to be a natural focus for scholarly research within the fields of risk regulation, organizational studies and risk perception, discussed further in section 2.3 and Chapter 3.

2.2.5 Developments in commercial risk management during the period

Whilst the structure of public regulation of banking was changing, with the public policy shifts of 1986 and 1997, significant changes were also occurring in

banks' internal approach to managing commercial risk. The advance of information technology, and developments in the governance of risk and corporate capital, introduced more precise methods of categorising risk and more complex means of manipulating it. Four developments in commercial risk governance are here highlighted as significant to steps in the shaping of a dedicated Risk Management function in banking, culminating in the creation of Chief Risk Officers, whose relevance as a research focus is the concern of this chapter.

The first of these developments is the definition of *operational risk*. Highly publicised failures of corporate control in the 1980s and 1990s⁸ supported a sense among the public, and in government and corporate Boardrooms, that common-standard controls for operational risk were desirable (Blunden and Thirlwell, 2010). Following a survey by British Bankers' Association in 1999, bankers in the UK agreed to specify operational risk as a new category of risk to be managed. Before this date, banking risk had been conceived in essentially financial terms such as credit, market, liquidity and contract risk. Operational risk recognised that broader commercial considerations are relevant to the business of banking. The Bank for International Settlements (BIS) (a committee of the heads of central banks) subsequently defined operational risk as

The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.
(BIS, 2006)

The move to recognise operational risk was significant for its acceptance by banks that, just because they take specific risks relating to money management in markets, this does not mean that they should ignore the general "risks of running a business" (Blunden and Thirlwell, 2010). The formal acknowledgement of operational risk required banks to look beyond money management in their risk reporting and consider such factors as fraud, employment and sales practices, protection of physical assets and systems, and business processes (BIS, 2006).

⁸ From among many discussed in the news media, Blunden and Thirlwell (2010) highlight for their impact on governance the cases of NASA's *Challenger* shuttle (1986); the Piper Alpha oil platform explosion (1988); the *Exxon Valdez* oil tanker spill (1989) and the collapse of Barings Bank (1995).

Whilst operational risk considered the detail of managing systems and people, at the same time a second, more strategic new approach was developing to recognise the strategic value of risk across a business: *enterprise risk*. This sought to bring a unified risk-awareness across various functions in a large organization. All managers – not just conventional financial risk managers – were to understand that they had risks to control, with senior management seeking to co-ordinate these functions. A UK definition of enterprise risk management (ERM) suggests that the activity should include

“Culture, processes and tools to identify strategic opportunities and reduce uncertainty... [taking] a view of risk both from operational and strategic perspectives”

(RIMS, 2010)

ERM programmes of management would typically pursue common definitions of risk, the setting of corporate “risk appetite”, and risk reporting to stakeholders (RIMS, 2010).

Banks also reconsidered the appropriateness of valuing risk according to the price of a contract at the time of a sale, since the present value of a contract is – indeed, should often be – different as markets move subsequent to the sale. The vulnerability of financial asset values to market sentiments was recognised in the creation of the *Value-at-Risk* (VaR) modelling. VaR for the first time forced banks to contemplate and formally recognise a “probability of loss” component in financial contract values. Specific results were seen as less important than the VaR calculation process itself, which was a new

“structured methodology for critically thinking about risk. Institutions that go through the process of computing their VaR are forced to confront their exposure to financial risks and to set up a proper risk management function.”

(Jorion, 1997)

For all the benefits of this “forced” contemplation of risk, the introduction of VaR also created a perverse incentive, which is of considerable interest for the present research; that is, that the

“freedom to use value-at-risk models in calculating capital requirements was attractive to banks because it generally reduced those requirements”
(Mackenzie, 2006)

The practical effect of this, in the longer term, was thus a pressure on banks’ risk offices to reduce the reported figure for regulatory capital by any available means. With the advent, in the early 2000s, of Chief Risk Officers, this activity came to be seen as a natural function of the role (see Section 2.3 below).

Finally in this group of commercial risk developments, a public debate on *corporate governance* sought to ensure that company Directors would acknowledge their responsibilities. The debate focused on Directors’ perceived responsibility to reconcile conflicting stakeholder priorities and other “collective action problems” for investors (Becht, Bolton and Roell, 2005). A series of government-sponsored reports, endorsed by UK industry groups, recognised the intrinsic merit of Directors showing public accountability (Cadbury, 1992; Greenbury, 1995; Hampel, 1998; Turnbull, 1999; Higgs, 2003). UK public company Directors recognised that the above-noted corporate control failures merited a concerted response and that shareholders might reward Boards who subscribed to a common standard of corporate governance. Corporate Boards became formally committed – at least through a voluntary code – to balance short-term commercial striving for profit against other, for example social, concerns to promote longer-term goods such as employment and sustainable patterns of growth.

Corporate governance may also be regarded as a function of operational risk management (Blunden and Thirlwell, 2010). Governance standards may bear on policies on the reporting of decision-making processes to stakeholders such as customers, staff, owners and regulators. UK governments responded to successive waves of public concern after each control-failure scandal by sponsoring a succession of public reports⁹. In 2003 the EC adopted Turnbull’s

⁹ Reports and recommendations were produced by public committees backed by Government and City interests, entitled Cadbury [*Financial Aspects of Corporate Governance*, 1992], Greenbury [*Greenbury Report*, 1995], Hampel [*Corporate Governance*, 1998], Turnbull [*Internal Control: Combined Code*, 1999] and Higgs [*Non-executive Directors*, 2003].

(1999) corporate governance recommendations into a European action plan with a new standard for corporate governance (Directive 2006/43/EC).

2.3 Creation of the Chief Risk Officer role

2.3.1 Why was the CRO role seen as necessary?

Banks created the role of Chief Risk Officer from the late 1990s onwards (Power, 2005), charging the holder with responsibility for pulling together three divergent risk reporting strands: The oversight requirements of the external regulator; the commercial risk models used by the traders; and the audit practices of internal control staff. The potential for contradiction between these roles may be readily seen, and is of interest for the current research.

Before the credit crisis of 2008, banks had customarily objected to any proposed new regulatory powers on the grounds that any such intervention restricts commercial risk-taking and so suppresses economic growth (BBA, 2007). Many bankers were – and, as this research will explore, perhaps still are – ready to suggest that inspectors' competence may be open to question. Meanwhile, coping strategies are little considered (that banks may have been finding ways to deflect the regulator's wish for them to alter preferred ways of working). It is possible, as suggested by Power (2005) and of present research interest, that a factor motivating banks to create the CRO function was a wish to reduce the need for other staff to change behaviour to accommodate compliance demands, or to enable more flexible interpretation of risk data from the start.

In the context of long-term debates around control uncertainties and unsound assumptions (Porter, 2010), financial risk managers had, with regulators' support, increasingly adopted econometric controls – that is, money-derived numerical measures of performance (Mackenzie, 2006). This activity appeared to suit the interests of all concerned, by offering the appearance of objective truths and hence fully accounted-for risk (Cox, 2008). Traders were able to define risk using plausible descriptors (value-at-risk, stress testing) and to convince the regulator that these could serve both regulatory and market-making

functions. This use, or abuse, of risk models and their language is a natural focus for research when considering the CRO experience.

Although econometrics became a normal form of encoded risk control, it is also apparent that two different interpretations of the task of “risk management” have been in use: public-interest hazard prevention, and commercial enterprise (Porter, 2010). Even though these two approaches shared some of the same words, practical interpretations differ, and these differences are also of interest where participant experiences are to be revealed through new research.

As seen in section 2.2 above, there have been pressures to demonstrate greater control of business risk, and specific recognition of stakeholder interests, in parallel with banks’ continuing development of management tools for conventionally recognised financial (that is, credit and market) risks. Taken together, these developments evidence a move in the 1990s towards more formal systems for risk management, corporate governance, and a culture of risk-awareness. Increasingly looking for reassurance by formal auditing of risk, government and industry were investing in “formal, generalizeable systems of control”, with formally defined risk understandings replacing earlier “informal sources of [risk] intelligence” (Power, 2007).

More auditable risk systems might be expected to be more transparent, enabling better public scrutiny and wiser questioning of governance decisions and risk criteria. However, advances in risk governance occurred in parallel with the development by banks of a new tier of complex, risky and virtualised products collectively known as derivatives. Whilst the appointment of a CRO was intended to create a stronger internal check against excessive risk taking, increasing product complexity was in practice making such checking more difficult. CROs’ awareness of this problem, and their response to it, merits scholarly research.

Research may also help to establish that the CRO in a bank may be responsible for a far higher level of risk than their counterpart CROs in other sectors. Although, within a general definition of operational risk and corporate

governance, a risk officer in any corporate organisation will have a generic interest in public risk protection (Blunden and Thirlwell, 2010), banks present egregious levels of risk. Whilst, for example, the CRO of a public utility company may be subject to public hostility in the event of a catastrophic failure of service, this would not be expected to have the same economic and social impact as the failure of a bank. As illustrated by the failures of Northern Rock and the Scottish retail banks in the UK during 2007 – 8, the price of risk protection, in the form of a publicly-funded bank rescue, may be beyond many people's capacity to conceive (Christophers, 2012). Banks themselves also bear large costs of self-protection in the form of setting regulatory capital (cash which cannot be traded but, as specified by Capital Adequacy rules, must be held on account to cover any sudden liabilities). To bankers' satisfaction, of course, the potential for massive profit makes this regulatory cost easier to tolerate.

Within banks, since deregulation in the 1980s, a culture of separation between traders and internal controllers appears to have hardened and may even represent, in some bankers' view, profit and cost respectively. Divergence in understandings of the concept of "risk", the difference between internal and external modes of risk reporting, between public and private sector risk managers, is not the only tension for the CRO. A potentially wider difference in understanding of the purpose of risk management exists between banks' traders and internal risk control staff. The CRO's responsibility for closing the cultural gap between traders and risk officers was perhaps their greatest challenge, and one which itself merits scholarly study.

The FSA has issued guidance, though not a prescriptive job specification, as to the areas of responsibility that a CRO should address. The FSA wishes, but does not compel, the CRO role to include being:

"accountable to the firm's governing body for the oversight of firm-wide risk management; fully independent of a firm's individual business units; [of] sufficient authority, stature and resources for the effective execution of responsibilities; [to] ensure that data used to assess risks is fit for purpose; [to] provide oversight and challenge of the firm's systems and controls in respect of risk management."

(FSA, 2010)

Meanwhile the bank-prescribed job functions of CROs, and their use of risk-metrics, have already been the subject of research (Power, 2004, 2005). However, the creation of CROs has raised other, untested research issues. Regulatory policy seems rationally derived, and appears to ignore coping strategies. The CRO could be regarded as embodying the bank's informal strategy of coping response to compliance demands. Significant issues arising from this are now considered.

2.3.2 CROs: Concerns and institutional pressures

A core question in relation to the CRO function is how far the officer might be able to stand outside the organization in order to avoid bias in appraising commercial risks. Reported experiences indicate a common and unwelcome discovery that the role is found in practice to have limited power and so lacks traction over the behaviour of traders. Within even the most commercially consistent organizations, widely varying cultures of control and incentivisation may prevent practical agreement on how to act on the overarching risk objectives.

One way to address this issue is to characterise it in terms of two opposite extreme views of the CRO, optimistic and pessimistic. An optimistic view of the CRO function might regard the role as a necessary and desirable development towards making sense of the many proprietary econometric tools for risk management initiated by banks' trading operations (even though it is common to see these models pressed into service as instruments of regulatory control). In this optimistic view the CRO is a force for good governance, testing risk controls for efficacy, acting as a conduit for good-quality risk information, shaping knowledge and influencing behaviour towards the fair achievement of corporate goals.

A pessimistic alternative view might suggest that the CRO has been given a token role, as a powerless figurehead or "flak-catcher", by being tasked with

making sense (or the appearance of sense) of diffuse streams of regulation. A CRO motivated by self-preservation might, in this view, be justified in devising procedures which gave the appearance of compliance (performative “box-ticking”) whilst working to avoid disturbing the marketing activities of the bank’s traders. Any questioning of this token function, or game of regulation, might incur summary dismissal (see Chapter 7).

CROs were nevertheless mandated – both by their Boards and the FSA – to deploy risk tools based on highly formalised, commercially-derived econometric analyses (such as Value-At-Risk modeling, Monte Carlo testing, and stress testing). Whether powerful or compromised, CROs may be expected to acknowledge how fragile a balancing act is needed to reconcile the often conflicting uses of risk analysis by traders, internal controllers, and the regulator’s case officers.

That a new senior management role should be widely created with specific responsibility for general (that is, operational and other, as opposed to financial-risk models) risk may indicate a widening acceptance of risk as discipline of general management, with the CRO literally embodying good governance. Research interviews may be expected to establish the extent to which CROs admit to recognising tensions in their daily working lives and how they might set about resolving it and to find out what, if any, range of coping responses CROs encountered or recognised in others, and the extent to which they were able to challenge inappropriate coping.

2.4 The CRO as a suitable focus for new research

For the reasons reviewed above, the creation of CROs was an appealing development for banks and for the regulator. As with many regulatory and control initiatives, difficulties may have been expected to arise between conceiving the initiative and successfully executing it. To make the role work in practice, the CRO may have to balance tensions between internal and external reporting responsibilities and loyalties. As a single point of dependency for corporate risk reporting, the CRO might carry an impossibly large responsibility.

For a CRO in a bank this responsibility is acute: in terms of value of assets at risk, and systemic stability in financial markets, it is arguably greater than for a CRO in any other business sector. Misjudged risk decisions in a bank may, as events have shown, affect entire national economies or business sectors.

As Power (2005) has suggested, it must be considered that the creation of CROs represents not a positive paradigm shift towards engaging with risk, but more a simple reprise of a blame-shifting manoeuvre. This manoeuvre continues from a long corporate tradition of such strategies in response to regulatory change. In Power's analysis the bank CRO role may be merely

“the latest in a long line of corporate ‘officers’ created in response to specific problems. ...Creating a dedicated officership category is part of problem definition. As a well-tried form of administrative innovation, officerships signal organizational seriousness about issues. However, the history of such innovations also suggests that CROs are a potential fad, which may be short-lived. ...effectiveness and legitimacy is constantly in question, and the role may be a dumping-ground for high-blame problems.”

(Power, 2005)

Early surveys of role definition among CROs themselves bear this out. Two studies (Deloitte, 2007; PriceWaterhouseCoopers, 2007) offered functional definitions of the CRO role, with varying levels of instrumentality and executive authority, and with operational efficacy seemingly dependent on the culture of the hiring organization. PriceWaterhouseCoopers (PWC) (2007) concludes that CROs did not yet enjoy strategic influence, perhaps because they were perceived as not yet having “won the right” to this in the Boardroom by demonstrating economic value. Even as they confirm their appointment to champion a nascent “culture of risk-awareness” in their organizations, PWC's respondents expressed consistent concerns about “delivering value” – possibly a coded expression of concern about long-term tenability (echoing Power, 2005) of a special risk designation.

Despite Power's misgivings about the precedents for new officers acting as blame-recipients, the widespread institution of a new senior management officer

remains a striking corporate phenomenon. This fact alone would justify studying it; all the more so since the officer in question is dedicated, at least in part, to making sense of regulatory risk demands.

For present research purposes, it may be hypothesised, for subsequent research verification, that the FSA's adoption of the control model of enforced self-regulation was seen as sending two opposing messages to the markets. The first, intended point was that regulation might more effectively be rolled out following dialogue with practitioners; by implication, the FSA expected market-makers' engagement in dialogue as a condition of licensing them to trade. The other signal, unintended but commonly inferred by practitioners – and presently to be explored – was that local informal interpretation of rules was now acceptable. This latter perception was reinforced when apparent conflicts of interest, such as serving bankers sitting on the Board of the FSA, appeared for some time to pass unchallenged (BBC, 2009). As the present research will investigate, bankers appeared to be little concerned that the possibility of enforcement visits presented any significant hazard to business or reputation. This dismissive view of the regulator persisted in spite of earlier signs of regulatory failure (such as the fraud-driven collapses of BCCI, Barings, and NatWest Markets) (Gapper and Denton, 1996). Even as British banks continued to be major long-term contributors to the national exchequer (Wallis/Bank of England, 2001), they were selective in self-reporting their risk-taking, both to regulators and shareholders.

CROs may be expected to have had experience of attempting to reconcile corporate risk appetite and regulatory policy. Their conclusions from this experience might be expected to include insights into coping, as one possible strategy, and the extent to which any forms of coping can be formalised; whether CROs in general fulfil their function as instruments of good governance (including the extent to which they have 'real' authority and power, and their level of engagement with colleagues and regulatory case officers); and to what extent coping, if found, may be seen as normative, irrespective of whether it is done with benign or selfish intentions.

Research might therefore seek to develop a question to establish whether CROs regard their role as effective in supporting best practice in corporate governance; and to examine factors that shape the exercising of executive power more generally. Some other concerns are also of interest when scoping an initial investigation. These are: The extent to which CROs see their own (and also trader and Board) behaviours as constrained, whether by external forces, by workplace cultures of acceptable or expected behaviour and by incentives; the extent to which defiance against regulators came to persist in the system, as supported by “coping games”; and the success or otherwise of regulators’ attempts to capitalise on existing internal control systems. Greater scholarly understanding of these points may, in turn, shed light on how to prevent the tendency¹⁰ of markets and regulators to over-rely on self-generated risk reports; what formal Risk Management achieves in reality, if it fails to engage with crisis; whether or not it may be possible to “design out” the risks which are perceived to follow on from newly-imposed controls; and how better to resolve the differences between “public good” risk and commercial risk, so preventing regulated groups from re-shaping regulation for their own ends.

A sequence of themes is emerging, suggesting the need further investigation which this research will pursue. Apart from relevance to developments in theoretical fields, the research topic is enlivened by its connection with current concerns evident in national and international news. Whilst the present research does not lay claim to a full causal analysis of the 2008 banking crisis, it is reasonable to note that the failures of control here described have had some bearing on that event.

A first theme is to examine whether banks exhibit coping responses to their regulator’s demands. If they do, research should then consider the range of such coping responses, and whether these may be seen as analogous with responses noted in other sectors. Research should also focus on the role of banks’ CROs in relation to these responses. Considering relevant theory as a starting-point for developing the research question, in Chapter 3, the project should aim to identify behaviour associated with coping, applying to the financial sector a theoretical

¹⁰ Noted in Mackenzie (2006)

approach which has already successfully been employed to investigate other sectors. The research should also aim to apply rationales arising from existing research to see if these can help an understanding of how one clearly definable practitioner group perceives the efficacy of regulatory interventions.

The research topic emerging from initial observations, historical context, and theory, is to determine whether bankers' response to FSA demands for information might collectively be characterised as "coping" noncompliance. As Chapter 3 will now explore further, apparently similar behaviour has been observed among other regulated business and professional communities. A preliminary form of the research question is therefore:

Do UK banks respond to the FSA's demands for information by "coping"?

A prediction, based on the sector's social history and theory (see chapter 3), is that coping may be found as a normative response among this community.

Subsidiary questions may later locate the main question more precisely within relevant fields of scholarship, such as theory of regulation and of organization. Such questions include:

If coping responses are evident, what forms do these take?

Are banks' coping responses analogous with those already found in other sectors?

Finally, addressing personal experiences of organizations' risk governance, this research elects to focus on a senior manager, whose approach to the role expresses how risk governance will be enacted: the CRO. As a limited and identifiable group of newly-appointed senior individuals, CROs may be seen as the personifying organizational risk response. A question linking all of these elements is therefore:

What is the role of UK banks' Chief Risk Officers (CROs) in relation to coping responses?

Locating these questions in relation to theory, in the following chapter, does not make them abstractions; they support a public policy debate about risk governance, following financial market turbulence which continues to affect many UK citizens. This debate concerns risk and protection of the public as consumers and taxpayers; and so, the levels of supervision, market failure and moral hazard that society may be willing to accept.

Chapter 3 will explore theoretical foundations for this research.

CHAPTER 3: REVIEW OF PREVIOUS RESEARCH

3.1 Introduction

Chapter 2 considered the origins of the CRO role, as a recent development in UK banks. It suggested why the problems facing CROs in banks may be on a larger scale than those facing risk officers in other business sectors. It further suggested that there are factors in the commercial history of banking which might be encourage bankers to adopt a coping approach towards demands made by regulators. One implication is that the presence of regulators did not act to curb excessive risk-taking among banks' trading staff. Chapter 3 will now consider previous research informing this topic.

As a notably inter-disciplinary concept, risk has generated several grouped theories, overlapping (with variations) between different academic fields. There are various taxonomies for hazard, perception, decision-making, control and compliance. These have emerged from the work of, among others, social theorists (Douglas, [e.g. 1992], economists (Power [2005], Goodhart [2006]), psychologists (Kahneman and Tversky [1979], Slovic [2004]), mathematicians (Bernoulli [1738/1954], Nash [1994]), criminologists (Sykes and Matza [1957], Becker H [1963]) and political scientists (Hood [2002], Rothstein [2002]).

A large and distinct body of literature also exists on the management and control of financial risk-taking. Among this, one might expect to find studies examining the nature of systemic failures by senior risk managers in banking, and the problems faced by these individuals as they try to make sense of sometimes conflicting demands.

Before turning to the literatures of regulation and risk perception, this chapter will first note other theoretic approaches to understanding the problematics of evaluating the social (and economic) contribution made by financial services: studies of financialization, and geographies of money and finance. It will also acknowledge a significant body of social research into employees' experiences in

corporate settings (including financial services), studying individuals who face pressure to comply or conform to norms which they find discomforting or even stressful.

Social studies of financial markets also encompass geographies of finance. Within this theory field Christophers (2012) reflects on “financialization” – that is, the increasing prominence of financial services within in national economies, and of finance activities within companies. Within this conceptual setting he examines the extent to which banks make be judged as making a real or “added value” contribution to the countries where they have a business presence. The Geographies of Finance approach also raises the issue of banks’ loyalty to any one host country, if banks do not routinely regard themselves as having the purpose of contributing to the public finances of their host country; although the sector claims, in its own defence, strong “invisible export” earnings (Haldane, 2010). In the UK, or indeed any other country where they operate, and as the present empirical study may be expected to confirm, many banks regard themselves as stateless – that is, not belonging to or owing allegiance to any particular national enterprise economy. Christophers identifies as the core geographical “banking problem” that much commercial banking practice has an essentially international nature, which presents a problematic for national economic accounting seeking to measure it. A related aspect of the problem is that financial-centre cities having become “increasingly detached from other cities within their nation state” McDowell (1997). The modern challenge, for social sciences as for regulators, is to comprehend banking as “framed at an international scale”, since seeing it only at a national level is akin to “extracting one piece from a larger jigsaw puzzle” (Christophers, 2012).

A further concern raised within this analysis is that the international nature of many banks’ activities may encourage their employees to regard themselves as being somehow “above” any one national, or even regional, control standard. This concern arise especially in the banking sector, as the freely portable, virtualised nature of many banking products means that corporate choices on the allocation of geographical presence, and reporting of profits, can be “relatively arbitrary” (Christophers, 2012).

The present research may expect to encounter this point in relation to the activity of banking risk management, in the form of bankers' known attraction to "jurisdiction-hopping" or "regulatory arbitrage" – that is, banks seeking commercial benefit from relocating their business activities (whether sales or accounting) into places where the local regulatory regime is seen to be more favourable. Banks' practice of this form of arbitrage may also have a cumulative detrimental effect on the quality of regulation, encouraging national regulators to compete to attract financial businesses by marketing their "relaxed attitudes" towards controls (Neu, cited in Christophers, 2012). This effect has potential significance for banks' internal notions of conformity to national controls, such as risk regulation and (prominent in UK news bulletins at the end of 2012) how much tax should be paid to the local exchequer. If national regulators have been assuming that banks' compliance is driven by a supportive attitude towards the national economic "project", we may anticipate that their expectation will be found to be misplaced.

Studies of the geographies of finance thus raise usefully, for analysts of regulation, the question of why a regulator ought to expect compliance from an entity which does not regard itself as having any local (nation-host) responsibility or ties. Within the limited resources and deterministic focus of the present study, geographies of finance are not a thematic priority but one may expect to find some linked concerns mentioned by present research respondents as informing their own circumstances.

Turning specifically to the literature concerning regulation of risk, it is apparent that numerous approaches to the task are possible and that context is a significant determinant. In the context of banking, for example, risk regulation concerns ways in which government may seek to prevent bank staff from engaging in excessive risk-taking behaviour. From among a broad range of scholarly approaches to regulation and compliance, three ways of examining these issues emerge as of direct relevance to the present study. The three approaches are: regulatory control and compliance; informal organizations; and the social psychology of risk-taking in individuals. The relevance of these three scholarly

focuses to the present research topic will be considered in the course of this chapter.

As noted in Chapter 2, the bank CRO is an inherently attractive focus for research. One might therefore expect existing literature to offer some explanations as to why regulation, mediated by a CRO, may not succeed in curbing banks traders' risk-taking behaviour. Explanations might be expected to account for how, within banking organizations, informal groups act to promote non-compliant responses to demands for information from the financial regulator's case officers. Previous research might also be expected to explain whether, and if so how, bank risk officers adopt coping strategies to manage conflicting demands for risk reporting.

This chapter will explore theoretical fields identified as relevant to the present research. Relevant themes in other research fields will also be noted in passing, although practical constraints prevent further detailed exploration of these. After addressing the focus of the sector and research, this chapter therefore reviews literature concerning regulation in action, social theories of organization and of risk cognition. It identifies where earlier research findings and theories might be expected to elucidate the problems faced by CROs, and perhaps to explain or predict their likely responses to the problems. Where previous research appears insufficient to explain CROs' concerns, this chapter aims to highlight where original research may improve understanding.

3.2 Literature concerning regulation

3.2.1 Why regulate banking risk?

There are many ways to identify, categorise, and attempt to regulate risk in a commercial sector. Approaches to risk management range from assertive pursuit of those who misbehave, with vigorous enforcement and criminalisation of offenders, to the gentler approach of advising, persuading or warning practitioners to take remedial action. As will be seen, financial regulators have over time used the whole range.

As noted in Chapter 2, the banking sector has experienced many shocks in the past, and a recent major crisis following the collapses of Northern Rock and the Scottish retail banks in the UK, and Lehman Brothers in the US. This would lead a researcher to expect to find studies accounting for the origins of support for the risk control regime in place in 2008, which was premised on the scholarly theory of enforced self-regulation. This chapter will consider such regulatory scholarship, and whether it adequately accounts for the scope of the banks' failures of control, for example by giving due warning of the extent to which incentive structures, conflicts of purpose, and the high stakes involved in bank trading may be insufficiently recognised risk factors. Historically, enforced self-regulation had been supported by regulators and the banking industry as a way of helping regulators to deal with complex products and massive volumes of trading data. However, as this research will consider, the attractions of this approach to regulation may, over time, have encouraged participants to overlook its underlying weaknesses.

Such literature informs the present study's intent to add to the understanding of factors frustrating regulatory design by presenting a new account of the origins of noncompliant and coping responses to regulators' demands for risk information. Although the focus of the present study will be the UK banking sector, with primary research among banking practitioners, this does not mean that the study is interested only in such problems specifically in relation to banks. Rather, the present study approach is that banks may be found to be a rich source of instances for studying non-compliant behaviour, as indicated by recent market shocks. This research is interested in origins of non-compliance with regulation; banks provide a topical setting in which to address the broader issue.

As a first step towards understanding banks' responses to regulatory demands, the following subsection will review enforced self-regulation as the dominant structure in the UK in 2008, identifying its theoretical strengths and weaknesses, leading exponents and critics.

3.2.2 Enforced self-regulation, its problems and critics

Enforced self-regulation holds a number of attractions for policymakers. Proposing the system as a solution for resource-stretched governments, Ayres and Braithwaite (1992) set out its strengths, summarised in this paragraph (quoted words are from this source). The system gains the co-operation of regulatees, by engaging individual firms in producing standards and negotiating these with the state. The state is then well-placed to require firms formally to accept and abide by these “privately written rules” – not merely through collective bodies such as trade associations, but with an individual commitment by each firm directly to the state. The state also retains the right to rewrite rules. The regulator’s resources are greatly eased by its transferring to the industry certain critical but labour-intensive functions, such as collating transaction data and explaining product design; it is argued (after Coase [1937]) that this transfer will prove “cheaper and more effective” – although not without secondary risks, as will be seen. In banking, this transfer of activity is especially significant, due to the volume and complexity of trading data, risk analysis and product design. Ayers and Braithwaite further argue that internal (business-side) compliance inspectors are “better placed to trap wrong-doers” because they have greater expertise in “subject-matter” and are better placed to observe the business in action. This nearness to the source of the activity to be controlled also makes the system, at least in theory, efficient and responsive to change.

The principle of leveraging the internal control capacity of business organizations may be expected to hold a natural appeal to regulators and their sponsor governments who wish to conserve public resources. However, as critics of the system argue, the leverage works only if supported by strong external incentives to manage risk. Although the employees of organizations with complex businesses – such as banks – are indeed best placed to be familiar with the risks, and to develop systems to manage them, a number of significant problems attach to the system, which are now considered.

Banks' history of adapting measurement systems to regulatory demands is a specific focus for Mackenzie (2006), who questions the "self-referring knowledge" of risk models. Extending a notion from Friedman that models act as "an engine not a camera", and with a similar argument to Goodhart (2006), Mackenzie notes that the introduction of risk measurement systems had the effect of changing the behaviour of the people being measured – and also often of those who do the measuring. Setting out a history of methodological concern about the generation and application of econometric models, which also resonates with Porter's (2011) work on policymakers' misuse of statistical assumptions, Mackenzie considers whether banks might ever be expected (let alone trusted) to self-regulate. Bankers' risk models may have an attractive "cognitive simplicity" which can be dangerous; that is, the models can give the impression that complex phenomena may be simply presented, concealing their underlying assumptions which may create a "performative loop between 'theory' and 'reality'" (Mackenzie, 2006).

The willingness of banks to "show" compliance through deployment of self-generated risk models is found to be less reassuring in the light of this debate: tracing the historic relationship between risk-models and markets, Mackenzie indicates that they have continued to shape one another, so that models should not be relied upon as truly objective measures. Taking as one starting point markets' widespread adoption of the Black-Scholes formula, which drove explosive growth of banks' derivatives trading, Mackenzie is concerned that its general use by bank traders "helped to create a reality in which the model was indeed substantively confirmed".

This analysis also highlights the problematic that risk modelling is compromised by being, to an extent, socially constructed; for example when underlying assumptions are ignored as a model becomes popularly adopted for general trading purposes. Porter's (2011) analysis of historic social studies similarly questions the eagerness of public administrators (and, one may reasonably infer, of public regulators) to rely on statistics as the unchallengeable "truth". This strand of social studies of finance thus urges continuing research consideration of questions of sense-making and the role of subjective human judgement in the

face of uncertainty; topics explored notably by Weick (e.g. 1996) and Kahneman and Tversky (1974, 1979, 1982) and here considered further in section 3.4 below.

Reviewing antecedent theories, Mackenzie (2006) also suggests that, in any event, it may never be possible definitively to claim that an econometric model has been abused, since models themselves are derived by means of an abusive process – that is, deploying, then coming to rely upon, assumptions which tend to be expedient to trading but may be inapplicable to the market situation in which they are used. Mackenzie also makes a useful distinction, reflected in bankers' comments in Chapter 6, between two forms of “models abuse”: Abuse *by* dogmatic use of models (creating the problematic of relying on inappropriate or unnoticed assumptions), and abuse *of* models (where a rationally-derived trading model is compromised by “street-level” corrupt practices, such as large-multiple running of tests followed by “cherry-picking” of the most commercially attractive results).

Despite this potential for abuse, from the regulator's point of view enforced self-regulation offers the prospect of balancing the considerations of commerce and public protection. From the commercial point of view, however, practitioners wish to see regulators' interventions kept within acceptable parameters: Too much intervention may suppress natural market growth, whilst too little may enable deviant enterprise to flourish. Prior to self-regulation, command-and-control systems of regulation adopted a utilitarian view that practitioners would regard strict compliance as a practical necessity (Hawkins, 1983; Braithwaite, 2000; Knafo, 2008). Yet it was also recognized that command-and-control might perversely encourage “rational” non-compliance (Viscusi and Zeckhauser [1979]); an effect which Ayres and Braithwaite (1992) suggest enforced self-regulation helps to moderate: “tightening of a standard may lower overall performance”.

A primary problem of self-regulation is any assumption that regulatees may automatically comply, perhaps out of some sense of ownership of the system. A more realistic aim for the regulator in this system is to secure “egoistic co-

operation”, argue Ayers and Braithwaite (1992). Enforced self-regulation, however, may have the effect of distributing decision-making, which introduces the differing viewpoints of various participants, each with their own perception of risk and compliance. As Beck (1992) suggests, regulated actors produce subjective cognitions and may even dismiss absolute truths when judging their own appropriate response to a risk (or to a regulatory demand). Because subjective risk cognition plays an important part in decision-making about compliance, this topic will be examined more closely in a separate subsection of this chapter (see 3.4 below). Since many business decisions must be taken in uncertain circumstances, individuals will make their own sense of the apparent risks and appropriate response; as the present research will explore, there are times when individuals see a regulatory prescribed response as irrelevant to the situation.

The present research will use primary investigation to explore how enforced self-regulation presents systemic problems which, in the presence of noncompliant regulatees, may severely compromise its efficacy. Observations of actors in many forms of regulated organizations¹¹ reveal some of these weaknesses of self-regulation in action. These problems are summarised in the following paragraphs.

For self-regulation to work, even with a component of enforcement, there must be symmetry of incentives to comply. Internal incentives (that is, to comply) must be aligned with external incentives (that is, to do business). Regulatees may also be attracted by alternative activities such as “systems thinking” (Seddon, 2008) or a “ritual” of apparent compliance (Power, 2005), which may involve less effort than actually changing their behaviour to achieve real compliance. At the extreme, a systems-thinking response may lead to the production of a “fantasy document” (Clarke, 1999), or of narrowly-defined

¹¹ Recent accounts of noncompliant responses to self-regulation include, in the public sector: rail network operators (Hutter, 2005), central government (Torriti, 2007), pharmaceutical product testing (McGoey, 2007), and hospital management (Kodate and Dodds, 2009). Commercial sector studies include: food production (Yapp and Fairman, 2005), shipping (Bloor and Samson, 2009), and chemical refining (Etienne, 2010).

compliance targets (Goodhart, 2006), invoking procedures which have no impact on regulatees' risk-taking behaviour.

The “fantasy document” is one extreme outcome arising from the problem of asymmetry of information. A regulatory agency, with limited resources, relies upon the industry to make good any knowledge deficits. Regulated actors control the input data in the form of their own reported figures and their choice of risk models deployed to analyse inputs. The regulator's control initiatives may be seen as lacking legitimacy if they are uninformed, as can happen when the industry does not co-operate to transfer knowledge. If frustrated in this way, a regulator may as an alternative come to over-rely on systems being in place and performing as specified; if important elements of the systems turn out to be a “fantasy” specified by the industry, the control begins to fail, potentially creating a crisis of regulatory legitimacy.

Asymmetry of information is one aspect of the wider problem of asymmetry of resources. The regulatory agency is more resource-constrained than the commercial firms, lacking the manpower necessary to maintain a consistent deterrent in the form of a sustained physical presence on banks' trading floors. Risk reports (summary trading activity stress tests) must therefore accepted as a proxy for the observation of trading behaviour.

Finally, self-regulation may incite a culture of minimal or “satisficing” compliance (Simon, 1956) – that is, making the smallest amount of reporting or change in behaviour which the regulatees perceive is needed to satisfy the regulator's case officers. Over time, an organization may legitimize various types of “routine nonconformity” (Vaughan, 1999). As a social construct of noncompliance this effect is further considered in section 3.4.3 below.

Ayres and Braithwaite (1992) further warn of the dangers of regulatory capture (“co-optation”) by vested interests, noting the dangers of “cozy local agreements”. Empirical study of financial regulators' failures of enforcement (Williams, 2008) suggests that regulatory capture may in fact be a normal state in financial markets, as a natural outcome of economic asymmetry: There are

“intractable constraints whereby... powerful economic actors [can] undermine and circumvent regulatory process. ...Enforcement initiatives that appear brazen on their surface [become] blunted over time through accommodation and a disjuncture between intention and practice, buttressed by essential power differences between regulator and regulated”.

(Williams, 2008, p311)

In plain terms, the conclusion is that “money talks”. Whilst financial sector lobbyists may remind each new government that banks are central to the UK’s national wealth creation, Black and Rouch (2008) offer a more nuanced view of “legitimacy criteria” for financial regulation. They suggest that tacit pacts exist between banks and the state, allowing any proposed regulation to be pre-assessed by the industry and supported or rejected depending on whether the industry regards it as congruent with current notions of appropriate democratic governance, constitutionality, functionality and declared goals.

Having considered significant problems, expected findings are now indicated in each of the three highlighted fields, starting with regulatory theory.

3.2.3 What a sector study might be expected to find: Regulation

Critical studies of enforced self-regulation in action, such as Fairman and Yapp (2005), suggest that regulatees may over time come to expect compliance to be a “negotiated outcome” after a meeting with the regulator’s case officer. Although Fairman and Yapp welcome enforced self-regulation as an improvement on command-and-control schemes of regulation, they warn that it promotes a softer conception of compliance. In the context of a food industry study, they find that enforced self-regulation encourages reactive decision-making and casts the enforcer in the role of “driver” of compliance.

Other critics note that compliance may be meaningless if defined by user-produced econometrics (such as Toft [1996]; Hood [2002]; and Cox [2008] attacking statistical “illusions of certainty”) and note real adverse responses to

new regulations (such as Braithwaite J and V [2000, 2003]; Rothstein [2002]). There are also warnings that enforced self-regulation encourages a “systems tendency” (Seddon, 2008), “fantasy” control documents (Clarke, 1999), the unqualified pursuit of audit (Power, 2005) and risk quantification (Toft, 1996) as a substitute for human judgement. Indeed, Ayres and Braithwaite acknowledged flaws in their own proposition: for example, in a study of pharmaceutical industry, they note that although internal compliance officers have great expertise and “know where the bodies are buried” (1992, p 104), the officers cannot be expected to be willing to self-incriminate. If self-regulation were purely voluntary, they concede, internal compliance officers could be “more capable [but] not necessarily more willing to regulate effectively” than the regulator’s own agents (Ayers and Braithwaite [1992], p106). They predict that difficulties may arise if a business sector’s collective resources are directed into a trade association which then manoeuvres to “co-opt” or even “capture” the regulatory agenda. Pearce and Tombs (1990) warn that commercial firms must be challenged to prevent them pursuing profit without regard for public good. The present study will challenge, in particular, Ayres and Braithwaite’s assertion that empirical inspection will normally find firms engaging constructively with a regulator, and will instead propose that “coping” may be as common.

Another conception to be challenged empirically is Ayres and Braithwaite’s view that one may rely upon commercial staff members as “family”, whose compliance questions to colleagues will be answered, as distinct from regulatory staff, who as “outsiders” who may be ignored. This distinction cannot be applied in the banking sector where the dividing line between insiders and outsiders is more likely to be drawn between the trading teams and the bank’s own compliance team (Fenton-O’Creevy, Nicholson, Soane and Willman, 2005). In the context of banking, to be examined, the compliance function as a whole is widely regarded with suspicion and the benefits of the CRO being “family”-side are less than the regulatory theory anticipates.

Attempts to improve compliance, whether by tighter standards or tougher enforcement, may also be expected to run into difficulties. Some regulated

actors may weigh up the cost of compliance against the cost of noncompliance¹² and conclude that noncompliance is commercially preferable (Viscusi and Zeckhauser [1979]). If so, attempts by the regulator to raise the threshold standard for compliance may make well-behaved firms safer still, but will also perversely encourage marginally compliant firms to consider save on the higher compliance costs by ceasing to comply. Reviewing regulatory agencies' historic failures, Carpenter (2001) also cautions against their seeking to accrue power by promoting "the appearance of control" (as opposed to a better grasp of empirical detail). Overall, as Viscusi and Zeckhauser argue, in an industry where the regulator's authority is already unsound, the raising of standards may produce lower performance. The present study will look at whether this expected effect may be found in the banking sector.

A final area of doubt concerns the deterrent impact of enforcement. In this regard there are weaknesses both as to the understanding of what is to be enforced – under a "light touch" regulatory regime – and the extent to which regulatees expect or fear enforcement action. Shortly before the 2008 crisis, a permissive atmosphere had been encouraged both by government, the regulator and the industry. Following claims of a crisis of over-regulation in the UK (reviewed in Hutter, 2005), HM Treasury commissioned a review of regulatory policy (Hampton, 2004) which favoured a "business-friendly" approach, to be called "enterprise regulation". Hampton (2004, 2005) recommended that risk assessment should determine the focus of enforcement interventions and that regulators' first resort should be to offer positive guidance on compliance. This approach would rely upon business interests giving a "dominant consensus" (Vickers, 2008) support for controls based on enforced self-regulation.

The system was expected to work as long as it was supported by comprehensive and transparent risk assessment, to focus inspections and enforcement action on the highest-risk businesses. Ayres and Braithwaite (1992) offered an "enforcement pyramid": regulatory interventions should range from persuasion and warnings (for mild non-compliance) through civil penalties, and finally to

¹² Defined by Viscusi and Zeckhauser as the probability of detection multiplied by the costs if detected

criminal penalties and the revoking of licences in extreme cases. This staged approach was suggested to help a regulator to focus limited resources on areas of greatest concern and to reduce the need for visits to firms who are seen to be compliant. One expected consequence of this approach, also to be examined empirically in the present research, is that this may encourage sophisticated regulatees to practice making convincing representations of compliance in order to conceal a non-compliant reality.

Following the advice of Sparrow (2000), Hampton (2005) also proposed a “random component of audit”. As Carpenter (2001) also argues, it is desirable to limit practitioners’ “earned autonomy” by regular audit questioning. Hampton’s new control initiatives were also to be passed through a Regulatory Impact Assessment (RIA), designed to weigh commercial interests against public protection. Subsequently RIAs were criticized when empirical evidence emerged that they were themselves being manipulated by local political interests (Baldwin 2005, Torriti 2007).

Even before the 2008 crash, enforced self-regulation was also being criticized for its broad “susceptibility of policy processes to elite interests” (Vickers, 2008). This contrasted with the FSA’s contemporary view of desirable characteristics of self-regulation (see Chapter 2 section 2). One of Ayers and Braithwaite’s (1992) cautions had been a warning to regulators to avoid resorting to “unenforceable blandness” as a way of winning industry support. But as Black, Hopper and Band (2007) report, the FSA’s principles were welcomed by practitioners as easy to interpret in favour of commerce, as they were

“...drafted at a high level of generality, [using] qualitative, evaluative terms: ‘fair’, ‘reasonable’, ‘suitable’ [rather than] ‘bright line’ specifics... Largely behavioural standards concerned with, for example, ‘integrity’, ‘skill care and diligence’ and ‘reasonable care’...”

(Black, Hopper and Band, 2007, p 192)

Less than a year later, Black and Rouch (2008) concluded that the FSA’s “voluntary rules” approach was failing under the weight of commercial “interpretative interference”. Black and Rouch predicted that the 2008 market shocks would, for the foreseeable future, dismiss “soft” principles in favour of a

return to tough standard-setting. The introduction of hard rules is, they suggest, an instrumental activity which tends to be “most intense” after a systemic shock:

“Current financial conditions have resulted in a further surge.”
(Black and Rouch, 2008, p.218)

The coincidence of the 2008 market shocks with the present study may be expected to reveal research respondents experiencing a similar change in attitudes within their own employer banks. Alternatively, one might expect to find the banks clinging to the commercial advantages of interpretable soft principles, encouraging a culture of noncompliant behaviour. The following section will consider theories of organization which refer to this; these may explain or predict factors responsible for CROs’ experiences in attempting to secure compliance.

3.3 Literature concerning Organizations

3.3.1 Introduction

The problems of enforced self-regulation discussed above indicate that an organization being regulated may, in practice, make less effort to comply than the regulator expects it to. Where a regulator requires, or expects, the organization to offer assistance this is not always forthcoming. However, it would be unsafe to conclude from this that organizations somehow naturally prefer to be obstructive. To understand better the factors involved, it is necessary to consider how a bank regards its organizational purpose as differing from that of the regulator. A commercial organization’s aims, problems, interests and incentives will be distinct to itself, and to some extent to its business sector. Literature of organizations is now considered, with an emphasis on scholarship which addresses differences between their formally constituted structures and the informal practices typically experienced by employees. This literature also provides some valuable broader insights into the differences between formal management constructs and “what actually happens”.

3.3.2 The differing aims of organizations; the tension of formal versus informal

Enforced self-regulation, as noted above, relies upon a co-operative response from regulatees; that is, on their good behaviour. In practice, organizations produce a variety of group behaviours, some of which impede enforced self-regulation. Scholarly studies of organizations in relation to this concern are now considered. In making sense of the literature for current purposes, it is helpful to consider the broader picture of organizational function, against which behaviour is played out. This subsection will address this topic.

Scholars note that formal structures (*academically expressed as the organization*) exist in a continual state of tension with subcultures (*academically expressed as groups*). Hutter (2005) sums this up, in a discussion of risk response plans:

“Once... organizational scripts and re-organizations are in place it is not necessarily the case that they are complied with or co-operated with.”

(Hutter, 2005, p80).

Ulrich (2000) suggests that the tension has its origins in the structure of organizations differing from their capability. Formal structure, he says, matters less in reality to staff than “what the organization is able to do and how it does it”. Thus “who reports to whom” and “which rules [apply]” are secondary concerns for many staff. (A regulator who assumed that hierarchies will support the enforcing of controls would find this unhelpful.) Heller (1996) similarly argues that a business organization’s purpose is made evident not in its structure but in how it sets about its essential task of “increasing long-term capability”. Behaviour is distinct from structure: A complex organizational structure may conceal numerous and widely distributed informal groups of staff who do not comply with rules (Mullins, 1985). There is a “gap”, says Heller (1996), between an organization’s formal public representations – its published aims, structure and rules – and “what actually happens”. This gap is also informed by actors’ perceptions of their organization’s sense of purpose (Katz and Khan, 1978). Regulatory and banking organizations, for example, have differing

perceptions of the purpose of risk management, which may be summarised respectively as public protection and finding profit opportunity.

Attempts to control an organization, including by regulators, must constantly confront the “what actually happens” gap. That the organization’s own senior managers may not be able to do so is a concern of the present research, which reflects on the contrast between the formal organization and the informal groups within it (after Mullins, 1985). Where the organization has formal and published structures, such as every company produces, the individual’s acculturated experience of working in an organization is the product of many interactions: that is, the outcome of repeated perceptions and and interpretations of colleagues’ behaviour. An organization’s interactions with other parties, including regulators and individual members of staff, contribute to a view of itself which may differ from officially marketed versions: the informal organization is a form of “abstract structure caused by human intervention” (Mullins, 1985).

Differences of organizational purpose, and conception of risk, may deliver consequences which regulation did not intend, possibly including secondary risks. These “unintended consequences” were noted by Weber and are here summarised (after Cherkaoui’s [2007] taxonomy of Weber). Regulatees may respond with “instrumental rationality” if they perceive a regulation to be based on incomplete or faulty information; this form of sense-making will be further discussed in section 3.4. “Interdependencies” may mean that the desired outcome of a regulation is displaced by other actors’ interventions. The inappropriate transfer of a control rationale from one sector to another – such as financial risk analysis into public healthcare – creates problems of “ramification”. Finally, and a key concern of the present research, regulation may be subject to varying interpretation through different value-systems: Weber’s “polytheism”.

The informal group, or informal organization, has its own distinct subset of organizational scholarship. Variance between informal groups and formal structures is first addressed in Mayo’s (1949) digests of the “Hawthorne studies”

of a US manufacturing workforce: Mayo warns of the need to conceive formally designated “teams” separately from informal “groups”, as he finds that informal groups exert a stronger influence over collective behaviour. To support this, Mayo notes how production-line workers made informal local agreements to set a pace of work just sufficient to meet immediate targets but also to avoid hard physical effort and to keep future production targets low.

Gray and Starke (1988) have examined how organizational aims may be compromised by informal interpretations; observing that informal group subcultures are frequently at variance with the publicly stated aims of the organization. As observed by Gray and Starke, a significant origin of noncompliant behaviour is a conceptual tension between the formal organization¹³, which assumes *loyalty* as a basis for attachment to the organization, and the informal group, which asks only for *cohesiveness* among its members. Informal groups define themselves with reference to a shared private cause of some kind, which may include gaining collective satisfaction from acts of defiance against organized authority (Gray and Starke, 1988).

Differing concepts of organizational purpose inform how managers in public or commercial organizations interpret their own roles (Mintzberg, 1990). The trader’s instinct does not align with the regulator’s “unitary” or “public good” ambitions for his work, as described by Horwitz (1991). According to Horwitz, public-sector staff values may be expected to include: Shared common interests and objectives, harmonious enterprise, and relating to the employer organization as a common source of loyalty. These values contrast with the commercial sector’s “pluralist” conception of corporate purpose (Fox, 1966). Commercial actors more readily accept that their organization can include competing groups with local allegiances, recognizing that creative conflicts may spur on the development of new products.

Mullins’ (1985) “gap” between formal structure and informal behaviour may be seen as a challenge to self-regulation, which relies upon organizational structures

¹³ Which could refer to either a regulator or a commercial employer

behaving as prescribed. In reality, any published representation of structure (such as a hierarchy, organogram, or corporate annual report) may not indicate how decisions are taken in practice. The question of identifying “who’s really in charge?” is thus of critical importance to the operation of internal controls and to the personal efficacy of risk management officers.

This has implications for the CRO function and the present research which considers that function. Organizational theory suggests that, to be effective, a CRO may need to realize that (formal) “team” designations do not account for the underlying influence of (informal) “groups”; indeed, the CRO should expect the two to differ (Mayo, 1949). Second, an adept CRO may need to recognize that, unlike teams, which are formally recruited, informal groups self-select and converge around issues of perceived loyalty. Such issues might be expected to include response to a perceived disruptive intervention, such as a demand for risk information from a regulatory officer or CRO. In perceiving a demand as threatening, the informal group may characterize itself as a defensive unit whose self-appointed function is “collusion to modify formal working arrangements more to their liking” (Mullins, 1985, p531).

Organizational studies broadly concur that informal groups self-create around a perceived common purpose of “deflecting challenges to engrained practices” (Huber and Rothstein, in press)(also noted in Mayo, 1949; Katz and Khan, 1978; Broadbent, Jacobs and Laughlin, 2001). Of relevance to the present research context is Huber and Rothstein’s (2013) observation that an organization’s risk managers – such as CROs – may come under pressure to “amplify or attenuate risk assessments” because of their employer’s “values, beliefs and interests”. This pressure may lead the risk manager to cope by filtering and reinterpreting “engrained organizational norms, practices and beliefs” (Huber and Rothstein, 2013) until rule-violations become “normalized” (Vaughan, 1996). Consistent with this view, one may expect to find a bank CRO coping by attempting to maintain an “illusion of control” – for example, by “stage-managing information disclosure” (Huber and Rothstein, 2013) or promoting “fantasy document” risk analyses (Clarke, 1999).

Kagan and Scholz (1984) advise that some disengagement may also be ascribed to simple “organizational incompetence” – that is, regulatees misunderstanding or not knowing about a rule (Merton’s [1936] “imputed competence”). However, Kagan and Scholz (1984) also apply this notion of “incompetence” to a situation in which regulatees wilfully ignore the regulator; an effect which concerns the present research.

A related effect noted by Dorner (1996) is that, when “rule-violations” pass unchallenged, practitioners tend to devalue the authority of the regulator. As a result, where no other incentives to comply are present, regulatory compliance may be expected to decay over time. This decay effect may be more pronounced in a regulated business which has a “cultural legacy” of “show[ing] little inclination to conform” because its “professionals [prefer to] trust their own approach” (Kurzer, 2001). As “powerful institutions”, banks are well placed to “ward off claims for an alternative construction of cognitive framework and action plan” (Kurzer, 2001). The field research which follows in Chapters 5 – 7 will review found examples of these and other related ex-ante, deliberative coping phenomena.

Whilst these literatures site “rule-breaking” within theories of regulation and organization, coping is also a significant topic of concern for social psychology, considered in section 3.4 below.

The problematics of organisations where culture reshapes formal structures are discussed by McDowell (1997) among other facets of her gender-based social study of bank staff in the 1990s. This study – based, like the present thesis, on empirical work in the form of conversations with bank employees – notes that individuals’ conduct is susceptible to cultural reshaping by the dominant beliefs and attitudes which are brought to work by a distinctive type of employee, referred to as the “Type A” (who is typically aggressive and individualistic). As McDowell observes, organisations function by constructing attitudes and beliefs; in banks, she notes, there is a strong gender component to this. One practical manifestation of this value system is a predisposition to hire strong-willed (typically male-aggressor type) individuals in sales functions. Any other staff

who are not male aggressors – which as McDowell notes, implies women, but as the present research will consider, may apply to “back office” types such as risk managers – are likely to find will find themselves under cultural pressure to self-restrict to “a small number of acceptable ways of presenting themselves at work” (McDowell, 1997).

In a field study of providers in another financial service subsector (insurance), Leidner (1993) notes a similar pressure on workers to conform to expected stereotypes, generating “problems of self-identity”; “having to be, while at work, someone they did not want to be” is a source of stress, and hence a possible driver for coping (Warr, 2002), a causal connection which is of interest for the present study. Leidner (1993) also notes that financial employees faced with aggressive “norm violation” by powerful others will adapt their own behaviour to accommodate it. This corroborates Vaughan’s (1999) findings of “normalization of deviance”, a process in which employees perceive themselves as lacking the authority, or support of others, to challenge assertive rule-breakers.

These studies inform an understanding of how employees’ sense of self can have an impact on their cognition of what constitutes accepted or acceptable behaviour. In the workplace setting of corporate banking, with markets trading in high-value financial contracts, a machismo-driven value system drives employees’ expectations of career progression and success. These aspects of self-image are thus constructed with reference to a hierarchy where assertive and single-minded behaviour is respected, but as a result devalues others such as women of child-bearing age and “non-A types”. This influence is most directly experienced in the workplace, where the present research will be set, although McDowell (1997) notes as further indication of the culture’s pervasiveness the male-aggressive orientation of work-related social activities outside the office.

The activities of supervision, enforcement and compliance may all be alternatively seen as forms of expressive behaviour within organizations. Whilst preoccupied with demonstrating their focus on carrying out compliance activity, both commercial and public-sector organizations may meanwhile “misjudge

serious risks”, sometimes with catastrophic results (Janis, 1972; Vaughan, 1999). Bardach and Kagan (1982) suggest that regulated actors may be expected to resent their regulator, as a normal response to any experiences of “site level unreasonableness” following, for example, over-zealous enforcement actions. On the regulator’s side, expressive behaviour may compensate for a lack of value-based justification of activities: beyond the mechanistic activities of reporting on compliance monitoring and enforcement, regulators find it hard to quantify the benefits of their “risk control accomplishments” (Sparrow, 2000).

Regulatees are though understood to be responsive to governments’ need for a regulator to deliver public reassurances (“rhetorical instruments”), such that all concerned can carry on with their business without attracting public concern (Clarke, 1999; Sparrow, 2000; Carpenter, 2001; Hutter and Power, 2005). Practitioners understand that they are required to play a part in public reassurance, with periodic shows of support for the regulator (Smith, 1995; Hood, Rothstein and Baldwin, 2001). Power (2007) even refers to the “signalling” activity of regulatory box-ticking as a “risk-based control ideal”. There is cycle of demonstrative activity on both sides, sending amplified signals of reassurance into the public domain; the regulator’s staff may also make “expressive interventions” (Sparrow, 2000).

The notion of regulation as an expressive or performative activity raises the topic of “creative compliance: theory of organizational behaviour considers the “creative reframing” of personal experience, rooted in Goffman’s reflections on self-presentation (1967) and the “frame” organizing of social experiences (1974). Research in this sub-field observes regulatory enterprise as a “drama”, complete with stage, performers and audience (Vollmer, 2007); alternatively (Snider, 1991) as an iterative “regulatory dance” of attempted enforcements and practitioner side-steps. Kaplan (2008) argues that at times of public uncertainty about a risk, control innovation will follow on from a “framing contest” – that is, that a new control may be proposed by whichever policy advocate succeeds in winning popular support.

Organizations respond to, and cope with (see 3.4) the task of risk management with divergent approaches: it is seen by business as best managing circumstances for private profit, and by regulators as providing public reassurance. The practical consequences of this approach, for CROs, will be noted in the discussion of empirical findings (see section 6.4). For the present, it may be predicted that the function of risk management will be found to be conceived differently by public-sector and commercial actors. These different conceptions of risk will now be explored.

A regulator, tasked with protecting the public interest, seeks to prevent commercial actors from taking undue risks; thus risk management, to a regulator, is a matter of restraining undesirable behaviour. In this view – to oversimplify – risk is bad and must be controlled, for example by compiling a risk register listing defined hazards to be avoided or mitigated.

Commercial actors, by contrast, primarily conceive risk as the opportunity for profit (Bernstein, 1996). In this view, risk cannot be fully defined or explained by quantitative techniques. A behavioural study of financial market traders has noted that they come to rely on “tacit, difficult to articulate, knowledge, heuristics, and private information”; they distrust “mechanical” calculations of risk because these can be “easily defeated by [the] human opinions and beliefs” which have greater influence on market price movements (all cited phrases: Fenton-O’Creevy, Nicholson, Soane and Wilman, 2005, p202).

Thus traders’ notion of a non-rational “sixth sense” for risk conflicts with a regulator’s approach to managing risk by rationalization, quantification and audit. From the individual trader’s point of view, a regulator’s case officer lacks the experience necessary to have developed a perception of commercial risk. Studies of the cognitive process (Zeman, 2008; Kahneman, 2011) suggest that it may not be possible for an “outsider” to grasp that intuitive risk perception may exist and have practical value:

“No amount of scientific exploration of a sense we lack will ever give us a feel for ‘what it’s like’ to have and use that sense... Subjective, first-person knowledge seems to lie beyond the reach of science.”
(Zeman, 2008, p191)

3.3.3 What might new research expect to find within the organization?

The expressive view of organizations, discussed above, suggests that regulatory compliance activity may sometimes be performative. Within this view, one may interpret banks’ creation of the role of CRO itself as a piece of regulatory performance – as Power (2005) suggests – designed to demonstrate publicly that banks take their public risk reporting function seriously. This implies a strategic form of “coping” at a corporate level, with CRO as an embodiment of coping. The present research should consider the notion that the CRO is a “coping person”, and that this notion moves beyond earlier theory. As a significant factor in human response to risk, coping is given consideration in a separate subsection (3.4.3 below).

To summarise on organizational theory: Literature suggests that a researcher may expect to find signs of decoupling between the formal rationalisations made by an organization, through its structures and systems, and the practical realities of how staff engage in daily work (Lipsky, 1980; Leidner, 1993; Warr, 2002). Such decoupling may induce “coping” responses, especially where individuals’ expectation of self-determination are under pressure – as when an external regulator seeks to impose new risk controls. This expectation is now considered in the light of theories of individual risk perception.

3.4 Individuals responding to risk: decisions, sense-making and coping

3.4.1 Introduction

Although, as noted above, significant literatures study regulation and organizational behaviour, it is also clear that human efforts to control of risk are, more than any other factor, dependent upon how an individual responds when called upon to engage with and manage risk. How individuals perceive their own contribution to any collective efforts to manage risk, and critically, how they make sense of the information and instructions given to them – or lack of these – may determine whether a system succeeds in exerting control, or fails to do so.

Compliance with a regulatory demand may be a direct response to some action from within the regulatory system, such as the threat of detection or enforcement action; or it may be the product of a judgement based on social risk perception. The literature distinguishes between regulatory theory (see 3.1) and human decision theory, some of whose key concerns are now noted.

3.4.2 Decisions and sense-making

Modern understanding of how humans make decisions from incomplete information follows from Arrow's (1958) utility theory, which considers how psychological and economic factors produce choices under uncertainty. Decision theory developed by way of taking into account practical study findings about the effects of neural phenomena on decision-making, such as heuristics and cognitive biases (Tversky and Kahneman, 1974; Kahneman 2002, 2011). A related group of studies meanwhile examined the impact of social interactions on individuals' risk perception (Fischhoff, 2002). These interactions inform public conceptions of risk and what is an appropriate level of concern about it, such as when considering "How safe is safe enough?" in relation to new technologies (Fischhoff, Slovic, Lichtenstein, Read and Combs, 1978). Related taxonomies of human interactions with risk have grouped significant factors into heuristic sets (Renn and Klinke, 2002; Saltelli and Funtowicz, 2005) and stages of a social

amplification process (Pidgeon, Kasperson and Slovic, 2003). Within the past 20 years, decision theory has also been directly informed by advances in the understanding of human cognitive processes – modeling effects such as sense-making (Weick, 1995), bounded rationality (Gigerenzer, 2002), affect (Slovic, Finucane, Peters and McGregor, 2004) and mirroring (Zeman, 2008).

Within the subset of risk-cognitive studies, sense-making has emerged as a key concept, following first use of the term by Merton (1936) to describe how a group may respond in ways not intended by a control system – as for example when regulatees reinterpret (imprecise) rules in ways that favour their own interests. Weick (1995) regards sense-making as a critical component of decision-making, supporting this with a series of forensic analyses of how informal groups made catastrophic decisions as a result of it (Weick 1990, 1993, 1996).

Regulatory theory, by contrast, is concerned with risk perception only as it informs the political wish to control and modify human behaviour, and so to inform the political enterprise of policy design. This field of theory is less concerned with psychology and more with the operation of bureaucracy, the suppression of unintended consequences, and how best to apply compliance controls (as noted, thematic concerns in the work of Ayres and Braithwaite, Clarke, Bardach and Kagan, and Sparrow).

Both corporate organizations and government agencies are susceptible to a tendency to make sense of their organizational purpose by seek self-comforting affirmations of their power to control their operational environments (Clarke's [1999] "fantasy documents"). The work of Kahneman and Tversky, Slovic, and others acknowledges that decision-making under uncertainty is not, in any case, wholly accounted for as a product of rational assessment: judgement is subject to the intervention of heuristics and biases which interpolate personal perceptions and preferences into the decision process. Decision-making under uncertainty may therefore be better characterised as the product of "bounded rationality" (Simon, 1956; Gigerenzer, 2002; Kahneman, 2002), in which rational evaluation

is understood to be limited by such factors as personal cognition and availability of information.

Biases within informal groups also intervene to shape organizational attempts at decision-making. Shaping informal groups' attitudes, individual risk perception may be seen as an outcome of a sense-making, or reconciliation, process of balancing conflicting or unclear formal demands; of creating apparent rationality out of incomplete information. Coping is the practical expression of this outcome.

Regulators' attempts to translate written rules into practical behaviour-change face a number of stumbling-blocks familiar to regulatory theory. These include regulatory unreasonableness (Bardach and Kagan, 1982), when the costs of implementation are seen to exceed its benefits; and organizational incompetence (Kagan and Scholz, 1984) when a new rule is ignored or misunderstood. However, a primary challenge is the phenomenon of coping among regulatees – a form of sense-making in action.

3.4.3 Coping and noncompliance

The following subsection considers the organizational and cognitive difficulties which are addressed by theories of coping, and suggests where the present research might expect to find evidence relevant to the theories.

In considering sense-making, Weick (1995) notes that individuals progress from sense-making to “coping” as a way to reduce the tension between formally designated controls and (often conflicting, informal) personal experience. For Weick, coping is sense-making translated into action as it attempts to remedy the “slippage between theory and action”; it is the human intuitive attempt to “impose order on a sprawling problem” even though that order is “only partial” and, critically, includes the “seeds of its own validation” (Weick, 1995, p123). Individuals first use sense-making as an informal way of organizing of risk information, then as individuals or in informal groups put into action a coping strategy, much as informal groups reinterpret the formal demands of the

organization (see 3.3 above). Weick's forensic studies (1993, 1996) suggest that one may expect to encounter sense-making among any new cadre of corporate officers who have been assigned a risk control task. In the present research, bank CROs may be predicted to conform to this expectation.

Organizations face the problematic that they must manage external pressures, including regulatory demands, in order to maintain their legitimacy. Yet, with a rationality inconsistent with the expectations of the external environment, the organization is likely to devise its own unique ways of functioning (Meyer and Rowan, 1977). Because of this disjuncture, a regulation which sets out to control an organization may fail to gain traction over the problems it seeks to manage. Heller (1996) warns of a "gap between the aims of... [the] organization... and what actually happens".

Theories of coping are of value in seeking to explain and understand the behaviour of employees who have been presented with conflicting demands. Literatures discussing the forms which coping may take are concentrated in two fields of research. Scholarship on organizational behaviour considers how organizations are structured, with interpretation of rules subject to modification by informal groups. Social psychology separately considers how individuals perceive their organizational environments and respond to the problems which may emerge. Both fields of scholarship are now considered.

Banks' risk officers may be expected to be subject to tensions between internal and external demands (Hutter and Power, 2005) and in particular, between the demands of regulators, sales staff, and Directors. Regulators require transparent public reporting of risk; by contrast, salespeople may be expected to regard risk reporting as an unwelcome distraction from selling; and Directors to be primarily interested in securing commercial profits. Studying the attempts of organizations and individuals to resolve tensions between various workplace demands, scholars have proposed theories of coping to explain and predict institutional and individual behavioural responses. These theories have been developed through studies of the organization (March and Simon, 1958; Meyer and Rowan, 1977; Lipsky, 1980; Turner and Pidgeon, 1997) and social psychology (Aldwin and

Revenson, 1987; Latack and Havlovic, 1992; Lazarus, 1966; Warr, 2002). Both fields of scholarship are now considered. By focusing on the responses of senior risk officers in banks to various pressures in their role, the present research provides a contextual setting in which both understandings of coping may potentially be observed and examined.

Formal rules (such as regulatory risk controls) may be expected to clash with organizations' informal routines of everyday practice (Mayo, 1949) – in banks, as practiced by sales staff and Directors furthering their commercial goals. On the one hand, a CRO tasked with supporting formal rules may find it practically difficult to maintain compliance where these rules clash, *ex-ante*, with “the (informal) way we do things around here” (Spitzer, 2009). On the other hand, the CRO may find it necessary to make an *ex-post* cognitive adjustment to “make sense” of inconsistencies. Coping might thus be regarded either as a conscious product of habituation, or a less rational after-effect of cognitive dissonance. As will here be discussed, organizational coping theory tends to the former view; social psychology coping theory to the latter.

Organizational theory connects the phenomenon of coping with a central problematic “assumption that organizations function according to the formal blueprints” (Meyer and Rowan, 1977). Whilst on the surface the organization represents that its control systems are fully functional, this representation may be achieved by means of “buffering”, “loose coupling” or even “decoupling” between formal structures and informal behaviours; organizational actors cope with conflicting pressures by “decoupling” the formal “organization chart” (“what they say they do”) from the informal, found version of structures or procedures (“day-to-day work”, or “what actually happens”) (Meyer and Rowan, 1977). Decoupling would, for example, allow a bank to publish externally rational-looking reports of risk exposures – Meyer and Rowan identify econometricians as typical actors in this process – which do not in fact account for the bank's internal rationalities or decision-making processes.

Organizational decoupling of inconsistencies can entail coping strategies which the present research may expect to find in banks: setting of ambiguous goals;

suppression of data on technical performance; fragmenting activities between “autonomous sub-units”; and, perhaps most significantly for a bank CRO, leaving individuals to “work out interdependencies informally”. Senior management of the organization may also consciously act to “maintain face”, despite knowledge of coping, by maintaining an “aura of confidence” around formal control systems (March and Simon, 1958) and may seek to “minimize and ceremonialize inspection and evaluation”, so as to prevent awkward revelations of local “deviations that undermine legitimacy” (Meyer and Rowan, 1977).

The present research may therefore expect to find a bank CRO experiencing pressure to employ risk modelling for the abusive purpose of “ritual” or “ceremonial assessment... [to] introduce ambiguity” and so “buffer [the bank] from failure” (Meyer and Rowan, 1977). In this analysis it is argued that coping is an ex-ante, strategic, and calculatively rationalised activity carried out with the intention of avoiding regulatory interference in routine business – a behaviour which Kagan and Scholtz (1984) foresee, and warn about.

A further relevant subset of organizational studies is the forensic analysis of disasters, with many scholars identifying the behaviour of informal groups as a significant contributory factor (Rolt, 1955; Turner, 1976; Perrow, 1984; Kletz, 1993; Dorner, 1997; Vaughan, 1999). Scholars including Vaughan (1999), Hutter (2001), Weick (1996), Turner and Pidgeon (1997) regard catastrophic control failure as a foreseeable consequence of informal groups’ attempts to reconcile the difference between the formal organization’s idealized version of the world, and the reality experienced by employees. Turner (1976) argues that organizations unwittingly “incubate” catastrophic control failures because they find it difficult to conceive how a problem may occur in a given system; Perrow (1984) suggests that it may be impossible for a modern organization to comprehend its own complexity, so that sooner or later its close-coupled control systems may be expected to generate an unforeseen “normal accident”. Weick (1996) examines how inflexible organizational hierarchies of control may induce a cognitive response, “sense-making”, which has repeatedly generated fatal consequences. Turner and Pidgeon (1997) alternatively suggest that

organizational culture produces a form of selective attention, whereby informal groups filter and reinterpret external demands in ways that fit more comfortably with formal organizational demands and informal practices.

Social psychology theory, by contrast, considers how risk perception and affect (“what the demand looks like and feels like to us” [Warr, 2002]) may explain coping, studying individuals’ responses to workplace pressures for decision-making. This is also a relevant context in which to consider the activity of risk management in banking, which has been described by its practitioners as working to “reduce uncertainty” so as to “promote exploration of opportunities” for commercial return on risk-taking (Blunden and Thirlwell, 2010). Such an approach acknowledges the centrality of “judgement under uncertainty” (Kahneman, Slovic and Tversky, 1982) to the banking enterprise, implying that the rational exercise of expert judgement in relation to uncertainty is the defining characteristic of the Risk Manager role. However, theories of social psychology (and of organization - see 3.3 above) recognise that informal responses to risk information may significantly disrupt formal exercising of judgement.

The present study argues that rational engagement with risk decisions is also disrupted by individuals opting to disengage from decision-making interactions – a behavioural “coping” response (Lazarus, 1966; Aldwin and Revenson, 1987). This behavioural response is typically present in circumstances of uncertainty where a decision-maker is additionally subject to various “stressors” (Warr, 2002; Skinner, Edge, Altman and Sherwood, 2003), which may discourage full engagement. It is significant both for general scholarship and the present research that coping occupies a separate theoretic space from decision science; whereas decision science tends to focus on rational calculation, coping theory concerns routines, social pressures and affective factors. Coping is regarded, in this field, not as a component of decision-making but rather as an alternative to it, or “flight” from it (Latack and Havlovic, 1992; Warr, 2002). Any strategy of coping – whether started deliberately or intuitively – is essentially reducible to “approach avoidance” (Skinner, Edge, *et al*, 2003): that is, either an action or “mental strategy” (Latack and Havlovic, 1992) to avoid making a decision, or

even to avoid engaging with the problem for which a decision is required (Lazarus and Folkman, 1984).

With this difference of approach in mind, this subsection now considers the phenomenon of coping as the appropriate focus for the present research, and as distinct from a focus on decision-making under uncertainty.

Social psychologists conceive workplace coping as a “person-environment transaction [arising when] an individual appraises a situation as stressful” (Aldwin and Revenson, 1987; Latack and Havlovic, 1992). Such coping may entail cognitive (sense-making) and/or behavioural (action-taking) efforts to reduce stressor “demands and conflicts... that tax or exceed a person’s resources” (Lazarus, 1966). Significantly for the present research, which is concerned with senior risk managers’ responses to uncertainty, coping theory defines a stressor situation as “characterized by uncertainty and important consequences” (Latack and Havlovic, 1992). Aldwin and Revenson (1987) argue that, since coping is a complex, dynamic process whose “factor structure varies”, it is less amenable to explanation by quantitative study (psychometrics) than by qualitative appraisal of situations in which it arises. The present study adopts a qualitative approach, as further discussed and justified in Chapter 4.

Warr (2002) identifies generic “stressor” factors, either “absent positives or present negatives”, which may be expected to have relevance for research set in a bank risk office. Of particular expected interest are the “absent positive” factors of personal control, good interpersonal contact, and valued status among colleagues. Warr’s “present negatives” may be expected in the present research to include: uncontrolled, imposed or conflicting demands; unsupportive personal interactions; and “normative conflicts” including a discomforting “pressure to adapt” to others’ norms. The same stressors are notably identified in empirical studies by Leidner (1993) and McDowell (1997) among financial services salespeople. Leidner (1993) notes as a central problematic the tension of “suppress[ing] the self [to] adapt to the requirements of the organization”, recalling Warr’s (2002) stressor of “excessive depersonalization... treating individuals as objects rather than people”. A coping response may be expected

where an individual is under pressure to accommodate “norm violations” by others (Leidner, 1993) – and even more so where there is an organizational culture of “normalized deviance” (Vaughan, 1999). Coping strategies which CROs may be discovered to use will be discussed following presentation of empirical findings¹⁴.

Becker (1963) has argued that, since deviant behaviour is socially constructed (when it is identified and labelled as such), it is necessary for other people cognitively to acknowledge a deviant act; when coping denies such acknowledgement, deviancy may pass unchallenged. This concern is a further motive for the present research: taking into account also the findings of Leidner (1993), McDowell (1997) and Fenton-O’Creevy (2005) among financial services employees, the present research may expect to discover at least some of the stressors which are preconditions for coping. That is, as many of the factors which social psychology identifies as generative of coping are already known to be present in banks, it is of natural interest to a researcher to discover whether coping is indeed found.

These constructs collectively support the notion of regulatees’ coping responses as occupying the gap between regulatory intentions and enacted practice in the regulated organization. The (already noted) subset of literature focusing on collective deviant behaviour arising in stressful situations (in the work of Weick, Perrow, Kletz, Clarke and Vaughan) continues to be augmented by a flow of topical case studies (such as Macrae [2007], Downer [2009], Kodate [2009] and Etienne [2010]).

Recent studies by Yapp and Fairman (2005, 2006) of food industry actors have identified and taxonomized certain marginally non-compliant behaviour, expanding on Hawkins’ (1983) original propositions. Yapp and Fairman conclude that noncompliance may routinely result from actors innocently or wilfully disengaging from regulatory requirements, justifying coping on grounds

¹⁴ Instances of coping phenomena reviewed in sections 5.3, 6.3 and 7.4; the “strategic coping” options perceived by CROs in section 7.5; and concluded upon in section 8.3.

of time constraints or other commercial pressures. This builds on theoretic notions of satisficing¹⁵ (Simon, 1956), performativity¹⁶ (Goffman, 1967) and culturally conditioned coping in commercial settings (Dorner, 1996) where

“breaking safety rules is usually reinforced, which is to say, it pays off. [The] immediate consequence is only that the violator is rid of the encumbrance the rules impose and can act more freely. Safety rules are usually devised in such a way that a violator will not be instantly blown sky-high, injured or harmed in any other way but will instantly find that his life is made easier”.

(Dorner, *The Logic of Failure*, 1996)

The general premise is that when their rule-violations pass unchallenged, regulatees tend to devalue the regulator’s authority. Gonzales and Sawicka (2003) study the operation of these “conditioning effects”: the non-event of catastrophe following rule-breaking “teaches” the practitioner that it is acceptable – and even apparently safe – to ignore the rule. Minor legitimations of non-compliance accumulate, over time, to produce to a mass acculturative rule-breaking effect across the organization. In a common phrase: “Familiarity breeds contempt”. A succinct summary is provided in Rolt’s (1955) study of transport disasters; railway maintenance staff whose non-compliance brought about a major crash had been

“so sure of their ability to carry out their work... that they had come to look upon the business of protection as a mere formality.”

(Rolt [1955], p128)

One must however avoid any easy assumption that non-compliance is automatically a product of opportunistic or wilful misunderstanding. As Braithwaite V. (2003) notes, there may be simple (motiveless) confusion between the formulation of a rule and its practical application. It may be

“far from certain... whether or not a person interprets the [compliance] request in accordance with its intent”

(Braithwaite, 2003, p276)

¹⁵ That is, producing a “good enough” result. From Simon (1956): People “adapt well enough to ‘satisfice’; they do not, in general ‘optimize’” (p136)

¹⁶ That is, acting in ways that give the appearance of compliance, whether or not in fact complying with the rule. Judith Butler adapts the term from Goffman (1967).

Acknowledging this problematic (of whether it is possible, or useful, to seek to attribute any clear motive to coping), the present research will not assume that regulated actors set out to commit illegal acts as such. Rather, it will investigate whether they conceive coping strategies merely as minimising regulatory disruption to commercial trading.

In a commercial organization, one might expect to identify various characteristic approaches to coping, ranging from individuals who challenge what they find (at the extreme, even, the “whistleblower”), to the quiet collaborator who simply wants to keep their job at any cost. The present research wishes to distinguish between habituated forms of noncompliance, which will here be termed “coping”, and more aggressive or opportunistic challenges to the regulator, commonly described as “gaming” the rules. The term “coping” will be used here as this may denote a range of behaviour including accidental (if favourable) non-compliance and negotiated regulation. The terms “gaming” or “game-playing” are avoided as these presume a more determined or instrumental approach:

“Parties may not know that they do not have a shared understanding; or some or all of them may realise that different views exist, and may seek to advance their own view as the correct one. Hence, it may be a misnomer to describe such contests as ‘game-playing’. A game generally relies on a very strong shared understanding between the players of the purpose and meaning of the rules. Thus, the term ‘game-playing’ implies an instrumental view of rules, rather than an interpretive view.”

Picciotto (2008, p.7)

For the same reason, the present research avoids the inference that imperfect compliance must have a malicious intention. As a less emotive term than “gaming”, “coping” allows for this ambiguity of motive, and so better suits the current purpose.

3.5 Emergent focus of the present research

From the above review of the literature, a new research topic emerges.

Research is needed to address the concern of how the ideals of regulatory design are, in practice, compromised. As the thematic grouping of literature in this chapter implies, this may be considered at three levels. First, at regulatory systemic level, it is necessary to consider factors which lead a business sector to disregard its regulator's authority. Second, at the level of the regulated organization, it is necessary to examine how internal tensions between profit and public accountability may fail to be resolved. Finally, at the level of the individual in a risk management function, it is necessary to examine how the performance of a specified risk-control job may become compromised by these internal tensions, and how the individual may come to be pressured into finding coping strategies in order to make apparent sense of such tensions and to survive in the role.

The present research will focus on an individual actor, the CRO. As a risk specialist, often newly appointed, the CRO was expected to protect the public interest, especially in the banking sector where the volume, value and complexity of risks are great. It will consider that actor as a focal point for understanding the onset of noncompliant responses to regulation. By studying how the CRO interprets the organization's stated goals, and experiences of cultural constraints limiting their attempted exercise of authority, it is possible to better understand how, by informal means, banks resolve conflicts of interest over regulatory purpose. The present research will address its task in the form of this summary question:

Do bank risk officers exhibit coping responses towards the regulator's demands for public risk reporting?

The, possibly central, role of the bank CRO in enabling or condoning noncompliance deserves research consideration of its own, which the present study will provide; Chapter 4 will develop this from a premise towards a research programme.

No study yet directly considers how bank CROs' risk perception is a factor shaping coping responses to regulatory demands. The functional role of the

CRO has been reviewed by commercial consultants (PriceWaterhouseCoopers, 2007; Deloitte and Touche, 2007; Moore Carter, 2009) and by academia (Power, 2005; Hall, Mikes and Millo, 2012). The current research aims to examine, by gathering primary evidence, the notion suggested by Power's (2005) analysis and here expanded, that the CRO is an agent for institutional coping.

Theories touching this proposition have been considered in this chapter, including antecedent models of coping behaviour and research into noncompliance in other sectors. To maintain clear separation of theory and practical elements, the methodological considerations and techniques deployed in preparation for the primary research will be addressed in Chapter 4.

CHAPTER 4: RESEARCH METHOD, DESIGN AND DATA

4.1 Introduction

Chapters 2 and 3 have looked at the emergent phenomenon of the CRO, reviewing risk regulatory developments and literatures of regulation, the organization, and risk perception. The literature has suggested that these three theoretical ways of considering how CROs engage with their responsibilities predict that they will display certain types of behaviour as a consequence of the situation they find themselves in.

Chapter 4 will now consider the most appropriate way to investigate how CROs respond to demands to interact with regulation and with their employer organization, and how they attempt to resolve apparent conflicts of purpose within their role. This chapter presents and reflects on the methodology to be used in the current research, considers limitations faced by the researcher and explains how these were managed. It explains why a qualitative approach was adopted and supports the choice of research design and respondent group, and the formulation of questions. It notes practical issues encountered by the researcher in the course of collecting and analysing the data, and considers questions of ethics, validity and reliability.

It is hypothesised that UK bank CROs resolve tensions in their role, including a possible problem of lack of authority, by resorting to coping strategies and sense-making. Original research is proposed to develop an understanding of the problem in three main aspects: regulatory, organizational and psychological.

The CRO is a natural focal point to investigate, as research understanding is directly informed by CROs' practical experience of the problem of defining their role. The research can attempt to discover: How does a CRO routinely attempt to make sense of a role which seems to be subject to many, often conflicting, demands? – a productive strategy is to ask CROs directly in person to recount their experiences of working relationships and of any challenges to their authority. As has been seen, the formal function of the CRO role has been

researched elsewhere, but less attention has been given to its informal, experiential aspects. In simple form, one might wish to ask of CROs: What is it like to be a CRO attempting to assert authority? What actually happens when you do? To be able to obtain answers to these questions from multiple CRO respondents would allow a researcher to assemble a composite picture of personal experiences of working relationships. Analysis of such insights would be of some value to scholars, practitioners of risk management, and regulators.

This chapter will consider what research needs to be done to secure data which informs the three aspects of the problem identified with reference to theory of regulation, of organization, and of social psychology. It will propose and discuss how these three aspects may be understood by investigating three working relationships which are central to the CRO's attempts to make sense of their role: These are the relationship with the regulator's case officers, with traders, and with senior management colleagues. Elements of the CROs' working relationships which correspond to the three theory groups are information disclosure, the informal organization, and sense-making among senior management.

Tensions in the CRO role may be predicted to arise from being required to discuss and manage potentially conflicting expectations about risk. These discussions involve the CRO with three proximal actors on an almost daily basis: regulatory case officers, traders, and senior managers. The CRO of course has many other interactions, but these three are regarded, as may be seen, by CROs themselves, as the most significant. To understand how the CRO addresses the tensions arising in the three key working relationships requires information about the content of these daily interactions. One clearly appropriate way to find out about this content is to ask CROs in person to talk about the interactions.

The rest of this chapter will expand on this proposed research approach, then describe how the research was conducted in practice.

4.2 A research approach: How best to gain understanding of CROs' multiple problems?

4.2.1 Defining a respondent group

The review of circumstances and theories in Chapters 2 and 3 indicates that new research might examine whether a CRO finds themselves, in practice, treated as the pivotal figure in a bank's production of public reporting to risk regulators. Understanding of CROs' personal experience of preparing such reports is the heart of the research topic. A priority is thus to obtain first-hand accounts of these experiences, from as many CROs as possible.

The target respondent group may therefore be defined straightforwardly as chief risk officers in UK banks, identified as such either by the formal title of CRO or by an analogous job function (and corroborated as such by the respondent).

In research discussing interactions between CROs and other actors, notably regulatory staff, banks' traders and Directors, a natural onward line of enquiry would also be to interview these actors. Pursuit of a greater quantity of collected data has been restricted by three factors, one conceptual and two practical, as follows.

First, the research focus is on the CRO experience. This research approach allows that the CRO may be found to "embody" a corporate strategy of coping compliance – that is, as an individual in whom the bank vests all of its need to maintain a deliberately distanced relationship with the regulator. Interactions with other parties are of interest only in so far as they inform the incumbent's perception of the CRO role.

Second, the resource constraints of an independent PhD project require a focus on core subject-matter. This can mean (reluctant) acceptance that it is not possible as an individual researcher to survey all actors who may be of peripheral interest.

Finally, and as found in practice, as the quantity and quality of material produced from interviews with CROs emerged, this evidence suggested that there would be a more than sufficient body of original material from CROs alone to merit review and analysis at this research level. As the research is concerned with the point of view of the CRO, it is reasonable that this view is the one sought in the empirical work.

The researcher notes that this is not the first investigation of CROs' perception of their role; however, the present research approach is distinctive, for reasons given in the remainder of section 4.2. Before 2008, the CRO role had already attracted the research attention of management consultancies whose motive for enquiry is self-evidently the pursuit of sales opportunities. Two such studies (Deloitte, 2007; Pricewaterhouse Coopers, 2007) offered functional definitions of the CRO role, with varying levels of instrumentality and executive authority. Since these studies have a commercial agenda to promote CRO confidence and recruitment, neither of them approaches the phenomenon of coping.

4.2.2 The research approach: qualitative, interview-based

Having identified respondents who can inform the present research topic, the practical questions arise of how to make a research approach, and the most appropriate technique of enquiry which will yield useful response material.

The decision here to pursue a qualitative, rather than quantitative, approach follows directly from the nature of the research question. The present research concerns attributing meanings to actions and the understanding of human behaviour and decision-making. Hence the "analytic induction" offered by qualitative research is a fitting research approach (Flowerdew and Martin, 2005). (By contrast, quantitative methods might best address concerns of amount and frequency, typically where there are many cases need to be compared or tested [Darlington and Scott, 2002; Flowerdew and Martin, 2005]). The behaviour of CROs is seen to flow from complex interactions of rule design, organizational

culture and private sense-making; these interconnected problems appear unsuited to numerical analysis but would be well served by a qualitative interview-based approach, as will now be proposed and discussed.

The decision was therefore taken to pursue this research using semi-structured qualitative in-depth interviews, usually with one interview per respondent but with an option for follow-up interviews, as for example when respondents have unusually rich or complex experiences, or have recently changed employer and are making sense of new circumstances.

Behaviour may be best understood if observed by more than one method (Silverman, 1993; Darlington and Scott, 2002), such as by considering contemporarily published comments in documents such as corporate and news media reports, as well as interviews. Such “triangulation” by multiple methods increases validity and reduces bias (Flowerdew and Martin, 2005). Consequently, this research pursued qualitative methods through semi-structured interviews with CROs practising in banks active in the UK, supplemented by a limited number of interviews with other relevant corporate officers, and continuing review of quality news media coverage.

This research proposes use of interviews with CROs to elicit narrated accounts of their own experiences of responding to demands for risk reporting; to discover whether these responses included coping; and if so, to investigate the nature of coping responses in the context of the banking sector.

Interview questions would need to be sufficiently flexible to allow for varying definitions of the CRO role; and not to anticipate the CRO’s allegiance to any one culturally-defined group within the organization, such as “back office” risk controllers or “front office” salespeople.

The research aim is supported by its empirical and evidential, rather than pure-theoretical, approach, noting evidence from respondents’ experiences.

The semi-structured interview format allows for qualitative and open research questions, tied to a question schedule which may also provide structured prompts to respondents to construct a narrative account of their experiences (“tell me about a time when...”), as a valid way for respondents to frame their concerns. Where several respondents may be found to frame their experiences consistently, this supports consistent analysis.

To consider, for a moment, other research methods which could have been used but were rejected: Paper-based questionnaires might have attracted a reasonable level of response but lack the ability of the semi-structured interview to realign quickly to focus on an emergent area of strong concern, or to identify and prompt detailed recall of a significant formative experience. A more mechanistic and less personal research technique such as an online questionnaire might also have been able to attract responses from other proximal actors, establishing knowledge of the points of view of regulators, traders and Directors. A series of telephone interviews might have secured some meaningful response – and indeed, telephone introductions helped to enable access to some previously unknown respondents. However, it quickly became clear, as expected, that CROs were most at ease with the interview format of a personal conversation in a private room with a trusted individual researcher; respondents themselves confirmed that personal confessional elements of their recounted experience would not have been committed to any other format, and certainly not to an impersonal questionnaire. Finally on this point, as discussed above, as a matter of practical project management it was also soon clear that securing access to spend significant time with CROs was itself a challenge worthy of a postgraduate research project. What began as a practical limitation soon emerged as a research strength, in that concentrating on CROs supported a depth of qualitative investigation which might not have been available had the research pursued a larger number of shorter encounters. By spending two or more hours with each respondent, the researcher had the latitude to explore more fully the three dimensions of problems set out in Chapter 3 – that is, CROs’ experiences of working relationships with the regulator, traders, and Directors, building up a composite picture of engagement with these sources of tension in the role.

4.2.3 Research typology and goals

Hart (1998) has reviewed the function of social research, surveying various approaches to conducting it and proposing a range of appropriate objectives and practical outcomes for the research task. Within Hart's framework, the current research is designed to present an *illuminative evaluation*; that is, it seeks qualitatively to highlight the existence of certain behaviour or attitudes in order to enable better policy-making and more appropriate practitioner behaviour. Such research need not seek to prescribe any policy follow-on. It examines *how* its respondents behave only as a potential key to *why* they do so¹⁷, and as to how their communications express sense-making. The research aim is exploratory, seeking to improve understanding of a phenomenon (in this case, the possible existence of creative coping responses to regulatory compliance obligations). It is also descriptive, with depth-interview question responses offering an empirical critique of the working hypothesis (that CROs respond to the regulator's information demands with various coping strategies).

An illuminative evaluation approach requires that respondents be willing, themselves, to explore and reflect in the significance of the experiences they are describing. In this regard, prompted recall of "stories" is a valuable research approach which is now discussed. Van Evera (1997) argues that, far from being unreliable data, spoken statements and stories have a distinctive research attribute:

"the insights of actors or observers who experienced [a phenomenon] one seeks to explain... often observe important unrecorded data... they can suggest hypotheses that we could not infer from direct observation alone". (Van Evera, 1997, p26)

Scheytt, Soin and Metz (2003) further suggest that asking practitioners to give an account of their experiences offers one of the best means of exploring "the characteristics of control" in a regulated market. A research approach based on 'stories' may thus be taken to apply in the current control context – regulated banking – as a reasonable way to embark on probing the phenomenon of coping.

¹⁷ Hart (1998) uses the term "ethnomethodological" to describe this approach, although I will not be using this descriptor as it is potentially misleading in the current context.

Particularly rich narratives might be expected where respondents perceive the regulatory regime to be onerous and the regulated activities are fast-moving, as in the current research context.

A research approach of soliciting narrated experiences offers certain advantages for the analyst: It explores the research topic empirically (how prescriptive demands from regulators were answered with sense-making behaviours). It offers the prospect of capturing personal accounts – albeit in sense-making form rather than literal truth – of experienced situations in which regulatory interventions produced either the intended behavioural changes among the regulated, or perhaps induced the production of fantasy representations of compliance. Table 4.1 illustrates the main benefits and potential objections to “stories”.

Table 4:1: Benefits and potential objections to “stories”

Benefits	Potential objections
Any primary research into coping responses (potentially including “rule-bending”) must overcome the obstacle of how to elicit meaningful responses from respondents who will be unwilling to self-incriminate. Stories are a non-confrontational form for exploring private rationales and informal sense-making.	A story is not a literal truth, so may be challenged as unrepresentative or even a fantasy. Scheytt and Soin (2003) counter that Weick’s (1995, etc.) findings over his long career cannot be dismissed as insignificant: Weick’s narrative-based studies suggest this may be the single most effective means of understanding sense-making in organizations; and that an account of literal truth is not necessary to establish such sense.
Stories remove the predictive, false-certainty (yes/no) and quantifying tendencies of linear question-and-answer formats. This also mitigates certain response effects (in particular Mayo’s [1949] <i>Hawthorne effect</i> - respondents second-guessing “right” answers in an attempt to ingratiate the interviewer).	The researcher may read into a story a meaning which is not inherent. Czarniawska (2004) warns against this “constructionist” tendency. Once aware of this, the research can resist the bias by maintaining self-awareness of his/her objective presence in the process.
Narrative enables various subsequent qualitative assessments, such as discourse analysis. This supports the aim of the current research to establish the perceived <i>existence</i> of coping behaviours, rather than quantifying or estimating the extent of these.	Narrative offers little support for quantitative assessment; but quantification is not the aim of the present research.

Analysts including Hajer (1995), Silverman (1993), and Czarniawska (2004) recommend the use of recounted experiences as a raw material for understanding sense-making in organizations. Hajer describes actors as generating “story-lines” from “various discursive categories to give meaning to social phenomena” (Hajer, 1995). Silverman commends interview-based qualitative research as a powerful way to access everyday sense-making:

“Researchers too readily assume that some topics are private matters to which we cannot get direct access. [But] by analysing ‘common sense’ in fine detail, research can often make a direct contribution to professional practice. ...Our common-sense knowledge about the way in which the world is organized is being used all the time – things may just be ‘hidden because of the simplicity and familiarity’.”

(Silverman, 1993, p185)

Czarniawska (2004) also notes with approval how, in practice often, experts’ “answers given in an interview are spontaneously formed into narratives”. Hajer (1995) suggests that this is because professionals like to reduce complex understandings and multiple social realities to commonly understood elements in the form of story-lines which can be retold, making for “coalitions” of peer-group understanding, views held in common which bind together informal organizations. These are, he suggests, important means by which an informal organization shares expertise in solving, or at least recognising, problems and in constructing responses to external challenges (such as, one might say, unwelcome demands from a regulator). Story-lines are thus an appropriate resource to consider in the context of the present research, which aims to probe how informal organizations make sense of, and respond to, such challenges.

Spoken statements are further regarded by analysts as a significant source of research understanding, on the basis that

“language profoundly shapes our view of the world and of reality, instead of being merely a neutral medium reflecting it”.

(Hajer, 2006, p66)

Exponents of research by soliciting spoken material (such as Hajer and Czarniawska) also consider that when recounting an incident, a respondent is deploying language to define problems and create meanings. Czarniawska points to workers' telling of stories as a way of circulating knowledge within their community; stories are a

“preferred sense-making currency of human relationships, (for) pattern-finding”.

(Czarniawska, 2004, p38)

Hajer (2006) argues that the study of spoken statements is an effective way to investigate how regulated actors interpret public policies of control. He offers some methodological suggestions which are now reviewed and accepted for use in the present research.

On a point of research in practice, it could be established by pilot interview questioning that opportunities for a “story” response are broadly welcomed, so supporting continued use of this approach in the main research. In speaking about a concern or incident, the interviewee can – and as established in practice, often does – volunteer a “story-line” as a way of producing meaning from a sequence of events. To make sense of events and to produce structure and meaning, an interviewee may assemble “ideas, concepts and categories” into a story. This summarises more complex factors into a form of narrated

“short-hand... which assumes [perhaps falsely] that the more complex narrative is available in the mind of the receiver and can be activated by giving a cue (‘you know what I mean’)”.

(Hajer, 2006)

Regarding subsequent data analysis, the thematic-analytical approach, and indeed the present research, does not start from an assumption of full understanding but progressively builds up understanding through a series of overlapping activities. Hajer (2006) suggests that appropriate elements of discourse-based research activity are: An initial desk research review of commentaries in the field (such as news media and learned journals); pilot

interviews and journal reading to develop a structure for depth interviews; then, following interviews with key respondents, repeated interpretative readings of interview transcripts. Through these steps, Hajer proposes, research may identify commonly acknowledged “key moments and incidents” through which respondents “produce meaning” – identifying salient factors and making sense of events.

Hajer’s approach is supported by Czarniawska (1998, 2004, 2008), another prominent analyst of spoken statements and sense-making via stories. Czarniawska advocates the research technique of studying transcriptions of semi-structured interviews as a valid method of collecting

“various types of inscriptions of ‘conversations’ that perhaps were never enacted”.

(Czarniawska, 1998, p66)

She argues that the “story” version of an event can be a relevant research resource even if it is a condensed, or approximated, account of earlier events or even multiple earlier conversations. As advocated by Hajer and Czarniawska, these methods offer an effective means of engaging with and analysing the culture of “storytelling” or “war stories” which is a prevalent cultural feature of the UK financial sector (as the current empirical work bears out: see Chapters 5 to 7). Review of narrated accounts of experiences is thus an appropriate research approach both for the nature of the question and the culture of the sector studied.

4.2.4 Ethical considerations

In preparing to question senior managers on the sensitive topic of non-compliant behaviour, it was necessary to keep in mind the potentially serious consequences for respondents: disciplining, possible dismissal, or even legal action in the event that a disclosure implied criminal intent. Of particular concern in approaching CROs is that the CRO role itself demands a high level of professional discretion. Besides overcoming practical barriers to access (gaining trust, getting past ‘gatekeepers’, understanding a new technical language), there is the subject-matter of the research: In an already sensitive field, the researcher

may be seen as asking respondents to breach professional confidence by disclosing non-compliance.

In line with current practice at King's College London and current commercial practice, ethical considerations were addressed with care. These included securing voluntary participation and informed consent supporting the purpose of the study; not putting participants at risk, and preventing harm; protecting and respecting privacy; and presenting respondents' views accurately (Creswell, 2003, pp63-67). Given the sensitive nature of the research topic, great care was taken to avoid compromising any individual respondent's position.

With the onset of a banking crisis in 2008, it also became clear that a researcher must take exceptional care to avoid identifying any casualties of the crisis – either institutions or individuals. Every interviewee was asked in advance of the interview whether there were any topics on which they would not be willing to be quoted; all interviewees re-confirmed that they were content to be quoted on condition of anonymity, including the researcher's assurance of care taken to anonymise any quotes and to remove any location, dateline or other data which might identify a respondent. Respondents were also given assurances on confidentiality of records, including secure storage of data; that audio and transcribed data are to be destroyed on completion of the research project; and that transcriptions and other work-in-progress analyses will themselves be stripped of any identifying features (hence respondents are identified only as "C27", etc., throughout the current research). For research integrity, original data remained open to research supervisors' access whilst this dissertation was being compiled.

In the practical context of the interview, ethical considerations were handled in a conventional manner: Each respondent was sent, and approved before giving an interview, a letter of ethical undertaking (see Annex 2). This letter follows the standard required of all postgraduate researchers for King's College London, with details specific to the present research project, and was lodged with the college's ethics office before fieldwork commenced.

4.2.5 Expert-respondents as true representatives

Research using experts (including experienced and senior business managers) enjoys theoretical support as a reasonable approximation for larger numbers of less experienced respondents. Cooke and Goossens (2004) conclude that experts' "implicit level of subjective confidence, or degree of belief" is more a source of comfort than concern.

Arnell, Tomkins and Adger (2005) argue that expert views may be regarded as a fair proxy for those of larger populations, as long as the experts are recruited with some formal criteria and procedures for ensuring reliability and credibility. These criteria might include, as they suggest in the academic field, "reputation, experience and published track record in the field, diversity of background, balance of views, and of course, interest and availability". In the case of UK-based bank CROs, the relatively small universe of potential respondents, and the seniority and expertise inherent in the CRO role, indicate a representative group.

Low-level triangulation provides reassurance as to the consistency of findings among respondents drawn from a limited universe: In this case, 35 interviewed CROs represented more than a third of the relevant identifiable population (estimated as almost 100 in 2007¹⁸); these respondents were themselves further qualified as representative by expertise (Arnell, Tompkins and Adger, 2005).

Regarding the quality of interview responses, it is also relevant to recall that, in practice, the main field research was conducted during a period of unprecedented public scrutiny of the banking industry, with extensive and concurrent public domain (media and political) commentary on the industry's control problems. Respondents were reflexive to this environment and were, as a result, more self-analytical and self-critical than might have been expected had the research been conducted in less turbulent times.

¹⁸ Based on a list of CROs known to British Bankers' Association, shown in confidence to the researcher

4.2.6 Semi-structured interviewing

Qualitative enquiry particularly assists an exploratory approach, where the issue is emergent (as here, in the case of the evolution of the CRO function, both as to role and in response to regulation which is itself rapidly changing). This approach enables construction of a language of reference where no formally structured language previously existed; and encourages “inductive inference” (Miles and Huberman, 1994) in the assembly of patterns from findings.

Social research interviews tend to adopt one of three alternative formats: unstructured, semi-structured or structured. If semi-structured or unstructured, they should be “in-depth” – that is, allowing time for more detailed responses – so as to probe more deeply for qualitative data (Martin and Flowerdew, 2005). Taking account how little was previously known about the research topic a semi-structured in-depth interview is expected to be the least restricting, most fruitful approach for expanding knowledge and allowing new perspectives to emerge.

The semi-structured in-depth interview is particularly advocated (by for example Hajer and Czarniawska) as a format which allows respondents to make sense of their experiences by “arranging events” into narrated stories (Czarniawska, 2004). This “guided” format enables the researcher to be flexible in exploring newly-found phenomena whilst at the same time using a defined set of questions (Gilbert, 2008). Furthermore, the semi-structured interview method removes any semblance of quantitative compliance checking, overcoming the inherent difficulties of a sensitive topic: The potential for self-incrimination when reporting actions which may have been non-compliant or even fraudulent (Lee, 1993).

The format retains some of the established limitations of interview-based research: It may transpire that respondents do not produce complete or consistent narratives; may bias their answers towards the perceived expectations of the interviewer; and may not admit to views on especially sensitive topics. These limitations are offset by “low-level triangulation” in the process as a whole (see ‘Validity’, in 4.3.3 below); and with regard to the research task which

is not to quantify any found phenomena but simply and qualitatively to establish their existence.

4.3 Research aim, rationale and questions

4.3.1 Purpose, originality and desirable outcomes

The research sets out to discover, and locate within existing theory, the nature of one regulated community's responses to a regulator's demands for information. The community under scrutiny is UK-based Chief Risk Officers (CROs)¹⁹ in banks.

Theories, and studies conducted in other sectors, suggest that coping²⁰ responses are prevalent and widely accepted among certain regulated actor groups. This phenomenon has not previously been studied in the UK banking sector. This lack of research knowledge may have persisted partly because of significant practical and conceptual obstacles to addressing it. Such difficulties include gaining access to an elite and closed professional group; obtaining and holding the confidence of respondents; and demonstrating sufficient authority and knowledge to maintain respondents' full trust and co-operation. This research has become possible because of the researcher's experience and reputation within the industry. A history of trusted personal contact with senior bankers has enabled access to, and maintained trust within, a respondent group that might be otherwise inaccessible.

The working hypothesis is that, as observed among managers in other sectors²¹, senior managers in similar roles sometimes devise ways to deflect the regulator's demands for information, but in the banking sector this deflection takes on more evolved forms of coping, including the institutional creation of a Chief Risk

¹⁹ Or other individuals with different job titles but CRO functional roles; see schedule of interviewees at Annex 5

²⁰ As discussed in Chapter 3, "coping" is here used to mean, in essence, actors interpreting a regulator's demands in ways that favour continuation of existing behaviour, with least disruptive intervention.

²¹ For example, and as previously discussed: healthcare in Bevan and Hood [2005] and Kodate [2009], food supply in Yapp and Fairman [2007], and chemicals manufacturing in Etienne (2010).

Officer (CRO) function. The research investigates the ways and extent to which the CRO (who embodies a newly-defined risk control function) maintains banks' established coping behaviours when responding to the regulator.

A desirable outcome of the research is scholarly understanding of the phenomenon of coping strategies among a previously unstudied group. It has been acknowledged at the outset that the target respondent group might be unwilling to discuss the coping phenomenon, both because of a convention of discretion in the sector and simply to avoid self-incrimination. A principal methodological challenge is therefore to obtain responses with robust research validity. The resulting material may also be expected to inform the wider policy debate around better regulatory design; and to offer a sound premise for further research (see Chapter 8).

Regarding originality: Given a range of possible factors sustaining the coping phenomenon, it is appropriate to explore the financial sector's responses to compliance demands by using a research approach which has proved useful in identifying coping behaviours in another UK regulated sector. Both the literature search and pilot interviews are seen to suggest that the current research can produce original insights. The likely nature of these insights is now briefly considered.

First, original research may be able to present new evidence, having used questions not previously asked, directed to a sample group whose experiences of a phenomenon have not previously been examined. The present research seeks to locate its findings with theory and studies of coping behaviour among other regulated groups (Bevan [2005], Fairman [2005], McGoey [2007], Kodate [2009], and Etienne [2010]). It may further consider this behaviour as a possible manifestation of a control "fantasy" (Clarke [1989, 1999]); or of "normalized deviancy" (Vaughan [1996]).

Second, the research approach specifically acknowledges three related disciplines: Rooted in an empirical study of behaviour in corporate

organizations, it also refers to continuing debates in the fields of regulation and risk perception.

4.3.2 Overcoming interviewer positionality and other obstacles

Each respondent arrives with his or her own expectations of the process and their own view of the researcher's position within this. At first the researcher is more likely to be perceived as an "outsider", becoming an "insider" for the purposes of sharing private knowledge as greater trust is established. Once initial respondents established that the research originated from a respected university and was known to the principal trade association, they were more willing to take the researcher into confidence. In this way one may maintain positioning as an objective observer, rather being assumed or co-opted by respondents as an insider (or "participant-observer").

With supervisor approval it was possible to use the university's livery for any printed correspondence, and the college email address for any message exchanges. This was important to avoid respondent preconceptions or identification of the research interests as coming from "one of their own". At the outset of interviews, the researcher presented as having no commercial attachment to the subject matter and no employment in the business of banking risk management.

As a research topic, coping might be expected to deter responses if approached quantitatively. It would be difficult to design a research structure yielding valid quantitative data on regulatory non-compliance among senior managers, because respondents may be predicted to be unwilling to share information in a form in which they are self-incriminated. As with any social field research, care is necessary to avoid directivity and response effects (Lapierre, 1934); in practice the researcher must anticipate and sometimes deflect respondents' impulse to offer an answer they perceive as the "acceptable" or "expected" version.

Respondents' resistance to agreeing to interviews was not found to be a significant practical problem; more so was the practical consideration of their maintaining and agreed clear time for appointments. The background presence of a financial market crisis throughout the roll-out stage of the research may account for non-attendance of two targeted respondents at appointed interviews; and continued unwillingness of some others to schedule an interview appointment.

4.3.3 Scope, focus and validity

In order to establish a realistic expectation of the scope of this research, and inferences from its results, it is appropriate here to set out what matter is included and excluded. This subsection will also confirm, with reference to research theory, that a limited group of respondents may be interviewed to establish that coping may exist as a normal response.

Regarding the question of breadth versus depth of targeted research group, the focus is on how experiences of holders of a specific role (Chief Risk Officer) reflect informal behaviours in the organization. Respondents' assertions are validated by comparison with other respondents' accounts and with external commentaries offered by market analysts, news media and published regulatory reviews. Hajer (2006) recommends final follow-up interviews with a few key actors as a method of triangulation – that is, confirming that the researcher's conclusions about the meaning and significance of key factors are both consistent and supported by respondents' own sense-making. In the present research, the second-interviewing of seven CROs helped to provide this confirmation.

Multiple-method research is typically advocated because of its advantages for triangulation (overcoming bias and establishing validity) (Silverman, 2004; Martin and Flowerdew, 2005). However, any research approach may introduce some forms of bias – even if only when a respondent second-guesses the researcher's intention in framing a question (Lapierre's "respondent bias" [1934],

or Mayo's "Hawthorne effect" [1949]). Triangulation²² helps to establish and adjust for a range of differing viewpoints, and interrogate the validity of any individual response. In the present research, limits of access and of absolute numbers of target respondents reduced capacity for triangulation. Low-level triangulation, in the form of comparison between 47 respondents' narratives, and external commentaries by market analysts, regulators and journalists, gives a necessary level of comfort for a qualitative study which makes no claim to offer statistical inferences. To reiterate: This is a qualitative approach whose purpose is to illuminate, explore and describe the phenomenon of coping, if found.

At this point it is also relevant to note management of researcher bias, discrepant information, and corroboration (triangulation) of findings by any alternative sources. Creswell (2003) notes that validity in qualitative social research does not carry the burden of connotation that it would in quantitative research (that is, of statistical "reliability, consistency, or generalizeability" [Creswell, 2003, p195]). Although the present research is not framed in such a way as to require numerical reliability²³, it is nevertheless desirable that objective verification is present. Low-level triangulation was effected by multiple readings and review of the interviews alternately considering participants' macro, meso and micro perspectives (Kodate & Dodds, 2009).

Finally, as to sample size and quality, with a limited number of bank CROs existing – indicated by pilot research respondents, and the British Bankers' Association, to number less than 100 in 2007 (see 4.2.4 above) – the issue of sampling was of less practical significance than merely succeeding in gaining access to as many of the target individuals as possible. As senior managers, the targeted interviewees could reasonably be regarded as a meaningful base of respondents, representative of the collective views of those they manage (see discussion of expert-respondent characteristics in section 4.2.5). The size of the

²² Flowerdew and Martin define triangulation as "cross-referencing of one piece of evidence with another in order to better determine what the actual position is" (Flowerdew and Martin, 2003, p157)

²³ Hammersley defines reliability as "the degree of consistency with which instances are assigned to the same category by different observers or by the same observer on different occasions" (Hammersley, 1992, 67).

target cohort may be expected to vary over time, and did so especially during the period of most concentrated fieldwork, 2008 – 9, which coincided with market turbulence inducing job losses and management restructuring in many banks. Despite good personal communications with respondents, their seniority and the circumstances an often-urgent need to attend to market emergencies meant that securing interview appointments continued to present a practical challenge. Respondents represented a high level of expert knowledge; all had qualified in at least one profession (law, chartered accountancy, or banking) at least 10 years previously, and in most cases nearer 20 years previously; and were currently or recently responsible for managing a headquarters-based team of risk officers. Thus the interviews accessed more than 350 years of accumulated professional experience. The eventual total of 35 CRO respondents (see 4.4.3) may be regarded as providing a meaningful base for empirical findings.

4.3.4 Framing the question

As noted in Chapters 2 and 3, the central research question seeks only to identify whether or not banks in general, and by implication their risk reporting officers in particular, produce coping responses when asked by the regulator to make a public risk report. In plain form the research question is:

Do bank risk officers exhibit coping responses towards the regulator's demands for public risk reporting?

As suggested by the sector's history (Chapter 2) and by theory (Chapter 3), the researcher might expect to find coping as a normative response in the banking sector.

Since this research is interested to discover the nature of the, hypothetically central, role of the bank CRO in enabling or condoning noncompliance, some supplementary questions arise to focus on the CRO's involvement.

As noted, pilot interviews established that it was reasonable to pursue an investigation into the coping phenomenon occurring in banks. For reasons of

maintaining respondents' trust and engagement, the interviewer could not pose the research or supplementary questions directly; this would amount a direct accusation of noncompliance. Instead, the topic of enquiry was approached by way of prompting respondents to recollect related incidents and concerns, in the manner recommended by Czerniawska and Hajer. The underlying questions were meanwhile borne in mind to direct the ensuing course of the conversation.

Supplementary questions were formulated to act as a guide structure for prompting recollections of incidents; these are now listed. In the event that coping behaviour was described as occurring, these supplementary questions guided conversation towards its perceived origins and the possible involvement of the CRO:

What role do CROs perceive themselves to play when coping responses are produced?

Is coping (or creative compliance) regarded as a normal, or even expected response to the regulator? How do managers rationalise any coping activities?

What forms do coping responses take? Are these analogous with forms of coping already found in other sectors?

The subsidiary questions serve to locate the core question more precisely within relevant fields of scholarship, such as theory of regulation and of organization.

The question of the CRO's role must in practice be raised not as a personal challenge to the respondent but by means of a lateral move: prompting CROs to recollect personal experiences of their employer's approach to risk governance. The CRO's own approach to the role may be taken to express how risk governance will be enacted and publicly reported. One might conceive of the CRO as personifying the bank's public reporting of risk – as perhaps did their employers, as this research aims to clarify. A final focal question, again

unspoken but drawing towards a research conclusion, concerns the CRO's authority in practice:

Is the CRO given, or able to create, any authority?

This suggests that a respondent may volunteer the perception that the CRO role owes its existence to a creative strategy of the Board: that the CRO has been installed as a means of coping with (deflecting) the regulator. If this is perception is offered, it is of interest to probe whether the bank and regulator are also seen to have recognised this as a strategy of evasion. The schedule of questions and prompts used in the research interviews is attached at Annex 1.

With research approach, target respondents, rationale and question premises in place, the final section of this chapter will present the actions taken in practice to conduct the primary research.

4.4 Conducting the primary research

4.4.1 Preliminaries

Introductory readings sought an overview of literatures linking regulation in action, organizational behaviour, and risk perception. The scope of review then broadened to include literature with a clear connection to the framing of regulation for corporate business and the corporate response to regulation. This helped formulate a prototype research question and to test it for validity among a pilot group of practitioners. (See also discussion of validity in 4.3.3 above.)

Directed introductory reading was initially within three analytical perspectives: regulation in action, organizational behaviour, and risk perception. This was followed by deterministic pursuit of commonest occurring and most cited references from that reading. Electronic journal searches also yielded articles consistently relevant to the current research topic. These activities generated an initial working bibliography of approximately 50 books and 200 papers. These were then re-reviewed for closeness of fit with the draft research question.

4.4.2 Selection and recruitment of respondents, pilot interviews; timing

Research respondents for initial or “pilot” questioning were pre-selected by the researcher, from existing knowledge of industry participants, to help to validate and define the scope of the later rolled-out research. The first three pilot group interviews were determined by availability following introductions from industry colleagues previously known to the researcher; however, a policy of “snowball” (further discussed below) enabled access to a wider base of respondents. Of the 35 CROs ultimately interviewed, only one was personally known to the researcher before the primary research commenced in 2007.

At the end of each pilot interview respondents were invited to nominate industry peers to participate in later interviews and also to provide or point to sources of listings of CROs. By these means it was possible to make initial and reciprocated telephone contact with 35 respondents not previously known to the researcher. CRO names were also found and checked with the assistance of the information offices of trade associations and online directory searches.

A research function of the pilot interviews was to test whether the research critique of theory had practical reference for the actors in the field. Exploratory interviews also helped to establish that the research could expect to elicit in-depth responses. These pilot interviews' stated aim was to hear about CROs' experiences of how their organization behaved in response to the regulator's requests for risk reporting. Pilot interviews further confirmed that the research premise would not be rejected as irrelevant, trivial, already addressed, or unfocused. They informed understanding of the topic and helped to shape a schedule of questions for the final interviews, with questions probing issues not previously reflected in the literature. Pilot respondents were typically Directors of bank business divisions, with responsibility for governance, risk and compliance matters; recruited deterministically, among practitioners known to the researcher. The first 15 respondents' willing co-operation indicated that the researcher might now expect further senior respondents to participate and to

discuss sensitive topics; and that the research topic is original. Having tested and adjusted the schedule of questions, the second phase (main) interviews could then be conducted at greater length.

The conducting of pilot interviews also provided a structure from which it was possible to reflect on positionality and interview techniques; and to reject certain assumptions: For example, one explanation for coping behaviours (conservatism, resistance to change, Rothstein's [2002] "attenuation") was found not to be perceived as a significant factor.²⁴

The issue of a representative sample of bank CROs is partially complicated by absence of a consistent definition of a CRO: whilst some heads of Risk have the formal title of CRO, many, by their own and others' accounts, "exist as" CROs without being precisely designated as such. Whilst ambiguities of definition and designation meant that there was (and remains) no exact number of CROs extant, it was nevertheless possible to ensure selection of appropriate respondents by employing some straightforward rules. The first and most straightforward of all was the precise job title "Chief Risk Officer", as checked on a respondent's business card and cross-checked in the bank's published organisation chart or Annual Report. Next, a similar job title might unambiguously indicate CRO functionality (such as Director: Head of Risk; or Managing Director: Risk). The researcher also asked British Bankers' Association (BBA) for sight of its own list of attenders at a regular, invitation-only, CRO Forum. Finally, early respondents were encouraged to nominate CROs known to them in other banks – a form of "snowball sampling" – although such nominations were also cross-checked with employers' literature, business cards, and published lists where available.

²⁴ As noted, counterintuitively, by Viscusi (1992), Rothstein [2002] and Carpenter (2004), strict adherence to regulation can itself be a form of strategic resistance to change. For example, Viscusi finds large firms using this technique to keep new competitors out of established markets: "capital costs of achieving compliance represent a barrier to the entry of newcomers into the industry. ...surviving (large) firms often have a strong vested interest in the continuation of a regulatory system."

Identification of respondents by these means produced a target list of approximately 70 confirmed individuals occupying UK-based CRO (or directly analogous) roles in banks during 2006-7.

Interviewer access to respondents was a significant research challenge, overcome by means of a combination of personal introductions from known colleagues (in each bank, or through the BBA), and telephone calls to “gatekeepers” (CROs’ personal assistants or deputies). Although persistent attempts were often needed to establish direct contact with and gain access to the earliest set of respondents, for the pilot interviews, by the time of the main interviews many CROs were more willing to talk – partly, as they admitted, because the financial market turbulence then underway made risk governance an attractive topic for discussion.

By these means the researcher achieved approximately a 50% sample of potential subjects – given the above caveats about role definition – a significant proportion of all identified bank CROs at the time.

A recent study (Hall, Mikes and Millo, 2012) has examined a small number of CROs; the present research sought to hear accounts from as many CROs as this project practically allowed. With a relatively small number of potential subjects, it was a reasonable research ambition to achieve interviews with half of the extant group as identified in 2007.

In case the data outcome of 50 subjects depth interviewed appears modest, it is worth here setting out some of the practical challenges of securing access. Even when meeting by way of an introduction from another CRO, trade association, or industry colleague, a target respondent CRO would not normally be inclined to give high priority to attending a two-hour meeting with an independent researcher. Booked interview times were often set several months ahead and many were subject to rescheduling, especially at after the sector-wide onset of crisis in 2008. Securing, and adhering to, a scheduled meeting time was a significant practical research challenge.

Regarding the historical *timing* of the interviews, it is notable that the majority of material was collected whilst a banking crisis was in progress (with Northern Rock during 2007, and across the sector from mid-2008). This crisis may be seen as presenting short-term tactical problems of achieving access – as noted above – but it the concurrent crisis in financial markets emerged, as interviews progressed, as an incentive to more thoughtful responses. CROs' co-existence with a crisis was spontaneously seen by many respondents as an opportunity to reflect on systemic problems, and to be more willing to discuss doubts. Thus, for all the practical problems it created, the banking crisis may be regarded as providing a net benefit to a research piece focused on regulatory efficacy.

On a related point, the progress of the financial crisis during 2007 – 2009 affected the answers given by respondents. Although this effect was not foreseen in the research design, nor specifically analysed within the remit of the research – whilst it is occurring, after all, the trajectory of a crisis is not clear – nevertheless it is appropriate to reflect on certain apparent changes in CROs' perceptions. The research conclusions in Chapter 8 include some reflexive observations on how the passage of time (in particular, during a crisis) was seen to impact on respondents' views.

4.4.3 Main data gathering

After the 15 exploratory interviews were conducted in London in two phases, between October 2006 and May 2008, final interviews were held between August 2008 and December 2009. 55 main interviews were conducted with 47 respondents including 35 designated CROs. Eight respondents, including seven CROs, were depth-interviewed more than once.

Interviews were typically managed over three stages: first an informal conversation to establish credentials and check whether the CRO would consent to a depth interview; second, a interview lasting typically 90 – 120 minutes; and, finally, a further 60-minute interview with certain respondents whose experiences were more complex.

All interviews were conducted face-to-face, except where practical circumstances prevented this; in the event, only two main interviews had to be conducted by telephone. All respondents gave consent for their words to be quoted on condition of anonymity. Analysis of the data does not disclose specific sources although the nature of each respondent's commercial activity is sometimes evident from their response content, for example when describing a sales incentive used for a specific product or market.

Data was gathered by the interviewer sitting with each respondent, with their express consent, recording their responses. Each interview was initially audio-recorded, producing an mp3 format sound file on a voice recorder. Sound files were then transcribed to Word text format, adding time codes for each two recorded minutes to assist back-reference to audio. Text transcription was to enable various analyses including highlighting of key recurrent topics and vocabulary; drawing analogies and observing patterns between different respondent accounts; and selective highlighting of self-contained story accounts of coping phenomena.

As discussed at greater length elsewhere (see general Introduction and Chapters 1 and 2), it is germane to note here that the interviews were conducted against the background of major turbulence in financial markets, with events which have subsequently been seen to mark a paradigmatic shift in relations between the banking industry, its regulators and relevant public policymakers. The timing of the research is noted to have had some effect on the nature of respondents' answers given, with more extreme examples of abuses being noted; however, it is not the purpose of the present research to identify levels of abuse as "typical" or "atypical" – merely to discover whether abuses occurred at all and if so whether these were internalised as normal behaviour within the routine operations of banks' risk management departments.

4.4.4 Data review and analysis

Following the method supported by Hajer (2006) and Czerniawska (2004, 2008), data analysis started by focusing on a review of transcribed interview texts, identifying story-lines and common informal terms used to describe and explain responses to regulators' demands for compliance. Next, highlighted patterns within the reviewed material were sorted into categories (three overall, sorting for the sector/regulator, organizational and personal views).

These three initial categories corresponded to distinct fields of scholarship, reached deductively from the earlier review of the academic literature, and also corresponding to a similar analytical framework proposed by Kodate and Dodds (2009) for the study of non-compliant behaviours in another professional context (healthcare provision). Within the three categories, further detailed sorting of themes developed inductively from repeated readings (Silverman, 2004).

In the event, concerns about possible problems of positionality were not found to have arisen: CROs showed no sign of being in awe of the research process; most were quick to offer frank opinions even where these contradicted their employer bank orthodoxy. The semi-structured qualitative interview format, with a trusted researcher, was in practice an effective medium for encouraging respondents to give narrated accounts of non-compliant behaviours and to express opinions on sensitive topics. For example, even at the pilot interview stage, respondents were ready to address the sensitive topic of the "maturity or otherwise" of FSA case officers. This led on to the questioning of subsequent respondents about a related sensitive topic, the perceived potential for abuse by FSA of confidential disclosures in order to mount high-profile retrospective enforcement actions (the "symbolic enforcement" risk identified by Hawkins [1983]).

The research yielded insights from a respondent group not previously questioned about their experiences of noncompliance. The data gathered, in the form of interview transcripts, offered the prospect of various forms of improved understanding, including: A new synthesis of related understandings of coping behaviour found in other regulated groups; of how informal organizational

culture produces unwanted outcomes from formal control designs; of the existence of “fantasy” control plans; and of senior managers’ heuristic conceptions of appropriate response when faced with irreconcilable conflicts of purpose.

The rest of this report, Chapters 5 – 8, will now review and reflect upon the empirical findings. The three-chapter review of research findings in Chapters 5 – 7 explores *how* respondents have behaved, as a potential key to *why* they do so. It will also consider how sense-making of incomplete or conflicting requirements may lead to coping behaviour. Although reflecting on various explanations in Chapter 8, this field research remains by nature exploratory, having aimed to identify the existence, and possible characteristics, of coping as a phenomenon among bankers. This is consistent with the research aim here presented, allowing for the possibility of empirical support for the working hypothesis that CROs produce coping strategies in response to regulators’ demands for risk information.

CHAPTER 5: CROs' RELATIONSHIPS WITH THE FSA

“The trouble with principles-based regulation is that there are parts of the market that are not very principled” (C12)

5.1 Introduction

The first four chapters of this thesis have concerned research context, theory and development of a methodology for empirical research. From this chapter onwards, findings and conclusions are drawn from the field research.

This research considers how, on behalf of banking organizations, risk officers respond to regulators' demands. It seeks evidence in the form of a CRO view of responses that may appear to comply with the regulator's demands, yet which on closer study show that no behaviour has been modified. Rather than attempting to advance a theory, the present study collects practitioners' accounts of real experiences, seeking to add empirical evidence to the body of practical knowledge informing the design of regulatory policy.

Chapters 5 to 7 will review findings from CROs' descriptions of their day-to-day interactions with the FSA and bank colleagues. These include accounts of some vivid but commonly experienced situations, such as physical avoidance of contact between traders and risk managers; bankers' selective reporting of risk data; and a commercial culture that belittles the significance of regulation.

The banking industry's control structure before 2008 may be described as a version of enforced self-regulation. It was appropriate to investigate whether bankers saw themselves as having supported this regulatory system as a matter of principled conviction, or merely as an expedient. Within that system, the creation of the CRO role may itself be regarded as part of a strategic “game of compliance” played by banks and some other industries. If a game existed, any appointed CRO may be expected to have experienced some personal conflict between responsibility to a commercial employer, on one hand, and the public

good, on the other. Empirical research findings will look at how CROs perceive and attempt to resolve that conflict.

This chapter will now review CROs' recounted experiences to see how they perceive the efficacy of the regulator: Was the FSA's stance seen as "light touch" (with a good level of understanding, if at arm's length), or "out-of-touch"? The chapter reviews, as here described by CROs, whether bankers regarded enforced self-regulation as an opportunity to push back against the regulator, to (in C11's phrase) "bargain down" or (as C3 puts it) "play the grey". The combination of complex rules and the FSA's policy of light-touch oversight has been widely seen as favourable to the sector's interests, but did it also inadvertently support senior managers who sought to manipulate risk reporting?

Chapters 6 and 7 will consider respondents' experiences of engaging with the commercial culture of the bank's traders and senior management, respectively.

Before moving to review CRO experiences of non-compliance, the next subsection will first consider the nature of interaction between CRO and FSA as formally intended.

5.2 The CRO role, and FSA interaction, as designed

5.2.1 The FSA's expectations of the CRO role

There was, and is, no universally binding job description for a CRO:

"the rise of the Chief Risk Officer has no specific institutional location or sponsorship, emerging from the practices of large financial and utility firms" (Power, 2005, p26)

As the regulator notes in a recent risk review (FSA, 2011), many senior managers continue to be designated a CRO (formally or informally) as long as their job function includes certain broadly accepted criteria:

“4.4 The person who is responsible for overseeing the risk management function is commonly, but not exclusively, referred to as a Chief Risk Officer (CRO).”

“4.10 The [effective] CRO... was also a member of the executive risk committee and had overall responsibility for risk within the organization.”

(FSA, *Solvency II*, Feb 2011)

A view more characteristic of the majority is articulated by research respondent C18: that whatever conflicted realities and compromises were found, the CRO should aspire to serve a higher purpose consistent with the FSA’s “orderly markets” mandate:

“There are pure motives... You want fairness in the market, you think that people ought to come with clean hands and behave appropriately.” (C18)

Some respondents understood their appointment as CRO as a general instruction to support risk-awareness in their employer bank. As C34 set out to show, a CRO could be a change agent sending out a message that

“risk-awareness is for all. That risk management is not just a task for specialist risk analysts. Everyone in the business has a responsibility for it.” (C34)

C5 saw the same obligation as a matter of promoting good risk governance throughout the bank:

“Good risk management is just good management. That’s it.” (C5)

That said, many respondents questioned the extent of the FSA’s own higher purpose and even its legitimacy as a watchdog for the business of banking; these doubts will be considered later in this chapter. More than one respondent referred to the genesis of the FSA as being “because the Bank of England had been seen to fail” (C23) after the Barings and BCCI crises; in this respect at least, any new regulator is assessed against a history of lack of regulatory agencies and systems which have failed to sustain practitioners’ confidence.

The present research did not set out to study a banking crisis specifically but rather certain preconditions for noncompliant behaviour in the form of compromised risk reporting, which may be expected to contribute to a crisis. It considers what happened to the power of a regulatory agency in practice when resisted by the power of the banking sector as a whole. Respondents were also asked what they perceived to be their bank's attitude to public responsibility – that is, managing risk to ordinary citizens. Evidence of a bank's engagement with risk to the general public might be expected to include support for the development of new risk governance initiatives, for example seeking dialogue with designers of regulation or setters of enforcement policy, or it could include work on advancing the concepts and models of risk management. The semi-structured interview approach also allowed for a discussion about any involvement in formal assessments of regulatory powers and compliance policy, or any interaction with organized public-interest groups.

Several respondents, such as C17, initially suggested that a system of enforced self-regulation shows that policymakers have a naïve faith in the agency of the market as protector of the public interest:

“I suppose everybody just somehow thought that the invisible hand²⁵ would do the job of reminding us about things like prudence and counter cyclicity during the boom times. But funnily enough, that didn't happen.” (C17)

As this chapter will now show, the common target of criticism was in practice not this “invisible hand” but a regulator whose vision was seen to have failed. This chapter therefore focuses on bank risk officers' response to expectations of the FSA: Did a “light touch” policy turn out to be, in practice, out-of-touch with market realities?

²⁵ A reference to Adam Smith's theory of market forces acting for the public good.

5.2.2 CROs' expectations of the FSA

C4 expressed a commonly-held view that the FSA, as a regulator inexperienced in banking supervision, lacked the expert stature and accumulated wisdom of its predecessor:

“After the FSA arrived, it was quickly seen as a box-ticking animal. Regulators started to hide behind the rule book. What’s needed are more experienced supervisors who understand business, ideally because they used to do it. The FSA just seemed to get rid of the collective memory which the Bank of England used to have.” (C4)

As predicted by Black (2003), the FSA as a new regulator was seen to struggle to command respect as long as banks continued to regard it as lacking authority, and hence lacking some legitimacy. CROs sensing this lack of authority answered the researcher’s open question “What is the regulator doing?” (Or “What is regulation for?”) with some cynicism. Some, such as C12, saw the FSA as the product of a historical accident, as a performative act by central government, a poorly conceived outcome of “a policy called ‘Something Must Be Done’” (C12). Another respondent, C17, explicitly supported Power’s (2005) idea that the CRO role itself is the product of the same regulatory urge – that is, the political expedient to “do something” which results in a new recipient for “blame-shift” within the organization:

“Let’s be realistic. The only reason CROs were originally created is because there was a moment when markets and regulators needed them to catch the flak.” (C17)

As will be explored further in Chapters 6 and 7, once in office CROs quickly came to regard their technical credentials as less significant than the attitude they present to co-workers, especially on the trading side of the business. A key theme emerging from this study is the realisation, common to all CROs shortly after arriving in office, that there are aspects of the role which were not clear from its job description. To a greater or lesser extent depending on the employer culture, the role entails engaging with the regulator’s reporting demands with a

combination of direct and indirect responses, simple verifications and sometimes complex obfuscations.

Whether each CRO ultimately regarded their own tenure as a success will be seen, over the following three chapters, to depend on how effectively they engaged with the regulator, the bank's sales staff, and its senior management. Their response to being appointed was affected by factors including the professional knowledge they brought to the role; colleagues' level of respect for the strategic task of public reporting, and tactically for the regulator's staff; and the extent to which they were prepared to negotiate around their own principles and preconceptions, to achieve a pragmatic (if sometimes non-compliant) way of working.

5.2.3 Regulatory policy issues seen to affect the CRO's relationship with the FSA

Respondent C12 offered a critical appraisal of the policy rationale which created the FSA:

“Why did we get the FSA? Self-regulatory organizations had been seen to fail miserably under the Tories. So, regulation is always in response to something. What happens is that the general public, Joe Public doesn't like whatever's happened and it's fed through to the politicians. The politicians say, right, well, something must be done, we're going to do something about this.” (C12)

As apparent from C12's view and similar comments from other respondents, bankers may see it as easy to look down on the regulator's staff, and may see themselves as enjoying a form of privileged exclusion from having to engage with public concern. Past complicity between practitioners and regulators was cited as a factor – that it suited everyone to not to raise any objections, at least as markets were making money. Again:

“It was all right for the City to look away from certain troublesome issues for as long as everyone chose to believe the assumption that the underlying market is not going to change.”
(C12)

It is a short step to conclude from this rationale, as respondents reported colleagues inferring, that the regulator is generally ineffective. This perception recurs in many respondents’ accounts of the regulator’s staff failing to secure banks’ wholehearted response to demands for information. In practical terms, the regulator’s efficacy was seen to be put to the test day-to-day as case officers asked for information and bankers responded to these requests. As will be seen, respondents offered many examples of negotiated, indirect or blocking responses, begging consideration as to whether the regulator was indeed receiving an expected response, or if not, what was happening in between request and response.

Regulators themselves accepted, at least after the 2008 crisis, that certain unforeseen risks including a liquidity famine may have tested to destruction “rational” assumptions and concepts of risk modelling. As the FSA’s own self-review of the crisis noted, the market shock raised

“important questions about the intellectual assumptions on which previous regulatory approaches have largely been built... (in particular) the theory of efficient and rational markets”
(Turner, 2009b, p39).

Respondents suggested that banks might have better helped their own cause by challenging the assumption of rationality – that is, that market prices might be relied on to find and securitise credit, or define risks quantitatively, or expect markets to self-restrain, or float an innovative financial product. Turner had admitted to a collective “intellectual failure to understand... huge systemic risk, the whole system was risky” (Turner, 2009a), and present research respondents shared concerns about certain fallacies which appeared to have informed regulatory policy. These are now considered.

Firstly, CROs objected to the “Newtonian rationale” (C4) that rules will “act as a lever” (C4, referencing Seddon, 2008) to restrain bad behaviour in regulated groups. That is, a regulatory control which expects people to modify behaviour as if responding to Newton’s Laws of Motion (action and reaction) takes no account of real human behaviour. In particular, it fails to recognise cultures of informal organization, and the role of affect in human decision making: the notion of a “moral economy”, or more plainly, whether it “feels right” to support a given course of action. .

Secondly, respondents pointed to the unreliable assumption by regulatory control designers that “all other factors remain constant” (*ceteris paribus*). As C17 says, background factors and assumptions do not in practice remain constant – especially at times of crisis:

“It’s all very well designing risk controls that function under ordinary market conditions, but surely the whole point is to be able to prevent the damage caused when market conditions change, especially for the regulator’s credibility?” (C17)

In fairness, it should be noted that policy advisers also acknowledged this as a point of weakness during the year after the 2008 shock. As one said, in the broader context of public protection, crises are not “distractions” from policymaking, they “are part of the job”; resilience to crisis is

“one of the most important parts of the whole system [because] these things have a huge capacity to throw off everything else.”
(Macrae, 2009)

In the case of the banking crisis, regulatory policy based on assumption of constant underlying conditions (“*ceteris paribus*”) self-evidently failed to allow for the complexities of global markets and human behaviour. Even as they admitted their own role in clinging to risk metrics, many respondents noted that the regulator seemed unprepared to respond to, let alone anticipate, the resulting market shocks.

CROs suggested that side-lining the regulator continued to be seen by bankers as normal even after the credit crisis, since their employers directed them to act as if profit, personal and corporate power were more significant motives than any

public good. (Such instructions will be directly examined in Chapter 7.) Respondents did not regard rational disagreement with this as a strong enough argument to prevent the industry “capturing” its regulator.

New research ground was indicated by a consensus among respondents that CROs are actors in a “game” of reporting (C4). Resistance to the regulator is seen as applying a form of risk homeostasis – that is, as C4 puts it, that bankers’ level of engagement with the regulator reduces as the level of regulatory demands rises:

“Absolutely there’s a tendency to shift towards playing the system if the regulator seems to be intervening too much. The more the intervention, the more people shut down their engagement with the regulator.” (C4)

On the other hand, this might appear to contradict the analysis, also common among respondents and axiomatic in regulatory theory, that too *little* threat of enforcement also encourages noncompliance. From this apparent contradiction, it is appropriate to move to consider what methods the CRO did expect the FSA to deploy when asking a bank to account for its risk decisions.

5.2.4 Ways that the FSA could call the CRO to account for a bank’s risk decisions

Respondents were invited to describe experiences of the various demands that the regulator could make for information and compliance reports. Although there are many specific instruments for compliance demands, in the form of a range of pro-forma letters, forms and reports, five principle types of demand emerged. These are now considered in turn.

Firstly, the regulator routinely asks to see an *audit trail*: That is, documents confirming the simple completion of a financial transaction or a product-based group of transactions. This type of reporting is intended to make clear the existence, participants in, value and timing of a transaction. Although this may be demanded as a matter of routine public accountability, as will be seen the

practical reality of receiving repeated requests to account for the same transaction is a source of friction between CRO and FSA.

Secondly, again as a matter of routine accountability, the regulator could ask the bank to demonstrate the validity of its chosen risk models by conducting and reporting on various forms of *stress testing*. The CRO was answerable to the regulator for calculating risk exposures and testing the soundness of the econometric risk models that the bank had adopted. Stress tests take basic transaction data and may either adjust various risk assumptions (such as, what if buyers start to offer a lower price for the product?) or run a product through a – sometimes very extensive – series of simulated trades to see how it performs under repeated use. The regulator’s willing belief in (possibly manipulated) self-reported stress test results was seen by many respondents as a sign of intellectual weakness – or acquiescence in a flawed system for the sake of a quiet life.

Thirdly, the regulator could ask the risk office to produce or update an assessment of the *regulatory capital* the bank now needed. This is an estimate of how much of its own money the bank should hold against the possibility that a deal or product may collapse. (Lacking the capital to cover their own losses in 2008, some banks had to ask HM Government for bail-outs; CROs reported that the regulator regarded public outrage about this as the main driver of FSA requests subsequent to the 2008 crisis.) As will be seen, one of the factors that most shapes a CRO’s experience in their role is how this mediation plays out day to day, as they attempt to reconcile the bank’s demands to tie up less capital against public concerns to increase it.

Fourthly, the CRO could be asked to report on how the bank accounts for its general *governance of risk*, including how it processed transactions and created the resilience needed to survive various forms of crisis. The regulator could ask about plans for surviving a projected crisis resulting from an internal issue, such as information systems failure, or external factors such as a counterparty going bankrupt. The CRO might be asked to report on a broad range of management functions including governance, continuity of business, or physical security.

Fifthly, under money laundering regulations and criminal law, banks have a duty to report early to the regulator the event of any *suspicious activity* by customers. Certain criminal transaction activities occur in recognised patterns, moving money around in ways that have no apparent commercial rationale. The onus rests on banks to spot movements of money which are inherently suspicious, and to report these. There are legal and regulatory penalties if a bank fails to spot a transaction which subsequently is found to have involved criminal money.

The following section will move on from CROs' expectations of the FSA to review their experiences in practice.

5.3 CROs interacting with the FSA: experience in practice

5.3.1 Introducing CROs' response strategies

In a view shared by many, C20 appreciated that the regulator's aims were valid but suggested that these failed to recognise that CROs' engagement with the regulator was powerfully influenced by commercial pressure from within the bank:

“The goals of financial regulation are essentially right. The regulatory regime is essentially a good one that's just been very badly implemented. The (regulators) just didn't do their job properly, did they? But then, many (bankers) were not actually very good at what they were doing either, ethically or intuitively. Many of us [CROs] thought their job was to find a way around regulation as opposed to implementing it, as to do [that] would be too like actually representing the regulator. What were they doing?”
(C20)

Equally, respondents described a “decent and honourable” (AD2) quiet majority of commercial bankers who conducted ordinary lending business and who regard their aggressive colleagues (especially derivatives traders) as “out on a limb” (AD2). Unfortunately, it is the traders who are regarded as having set the robust tone of risk offices' engagement with the regulator:

“Many [bank staff] look across their bank and say ‘I didn’t do that; I work in this bank and I didn’t know we did that. All I’m doing is lending money to a farmer, I make money every year and we have a good reputation and I don’t know what those [trader] guys are doing.’ There’s many more of those people than the ones who were, you know, out on a limb. And they must feel badly let down.” (AD2)

Reflecting on this mood among non-traders, respondents used a range of summary terms to characterise their employer bank, with some terms used consistently (such as by C15, C20, C23 and C27): one might be working for a “good bank” (still thriving), a “bad bank” (such as one that failed in the 2008 crisis), or an “incompetent”/ “out-of-its-depth” / “muddling through” bank (one whose ambitions had exceeded its skills, and was the credit crisis a chastening experience). CROs frustrated with the regulator’s perceived shortcomings did not necessarily feel this way because they worked for a “bad” bank.

The “out-of-depth” trading style was highlighted by a respondent who referred the researcher to an incident recounted in Lanchester (2010). Talking to a senior product engineer who had invented one of the first and most successful credit derivative products, Lanchester found her “baffled” by the enormous quantity of her type of contract that other banks were now managing to sell: “How are the other banks doing it... making so much money?” She was, says Lanchester, so used to applying her own rigorous approach to risk management that it “never occurred to her” that her competitors were making sales by the simple expedient of ignoring “all the risk controls [she] adhered to”.

The “bad bank”, by contrast, is reported by one employee CRO (C35) as knowingly using the apparatus of regulatory risk reporting to obfuscate:

“Like many banks, after the crash when the regulator turned up the heat, we set up a ‘bad bank’ subsidiary, put all our trash assets into it, and tried our hardest to sell it off. Keep it all off the balance sheet.” (C35)

As a broad finding, respondents were unanimous in expressing concern – sometimes verging on contempt – for the regulator’s limited understanding of the

practical realities of banking services and products. Lack of resource was widely recognised as a factor:

“We worked out that we were supervised by just four FSA staff who were covering the whole of our UK operation – that’s more than 12,000 of our staff.” (C34)

Given the consequent and acknowledged pressure on FSA staff to produce results from supervisory visits, CROs described a clear tension between voluntary engagement and consequent risk of punishment. Consensus emerged that it was normal to acknowledge the regulator’s staff and to be conventionally polite with them, but to avoid volunteering information. There are many subtle inflections and techniques of putting this approach into practice. These will be grouped thematically, in line with respondents’ descriptions of how they manage interactions with the regulator apparent strategies for engagement. The strategies may be broadly described in terms of demand management, organizational measures and presentational measures.

As earlier compliance studies predict, respondents such as C19 also suggested that there was a correlation between the pressure from the regulator to show compliance and practitioner willingness to achieve compliance – or at least the appearance of – by any means:

“There’s a growing concern among us that it’s not that firms are getting more compliant, it’s just that we’re getting better at playing the game of regulatory reporting.” (C19)

C19 raised this from the point of view of commercial concern, suggesting that the problem is less that reporting may be a form of game than that such a game might be stopped if too many industry-side participants are seen to profit from it. A key reason to conduct the current research has been to access accounts of “what actually happens” – how banks process, or fail to process, regulators’ formal demands into responsive action. Respondents have endorsed this research approach, broadly confirming the sector’s recognition that a light-touch regulatory regime may unintentionally encourage bankers to develop coping strategies in the interpreting of rules.

A central problematic of enforced self-regulation is asymmetry of resource between regulator and regulatee, and hence the regulator's restricted access to information. In the present context, CROs and their regulated colleagues recognised that source of regulatory reporting demands was an agency with limited resources; that is, that in practice the FSA could never deploy the staff resources necessary to exercise full oversight over all banking activities. Bankers were well aware that the regulator's staff had to rely on industry practitioners for practical know-how, product information, and access to data. Many respondents accepted that the FSA displayed some self-awareness about its own limits in this regard; many also offered views and experiences of this problem affecting their work directly. Views ranged from sympathetic support for the FSA, accepting that their task is hard, to frustration that regulatory staff appeared unable to understand their own task, to outright hostility even at the highest level of management.

Respondent SM1 provided the most vivid narrative of all of a hostile encounter between regulator and bank: his Chairman had once deployed the ultimate block against the regulator's requests, a tactic jokingly known as *regulatory arbitrage* (or *jurisdiction-hopping*). Acknowledging first that "FSA supervisors are under tremendous political pressure", SM1 describes how his Chairman uses a political threat to stop the FSA in its tracks. When the regulator "threatens" his bank, the response is

"just [to] say, right, we're going to move to another jurisdiction. Now as a regulator, what do you do? ...the bank's next conversation is directly from the Chairman to [then Chancellor of the Exchequer] Gordon Brown – and not just some minor Treasury man – and it goes like this: 'Now Gordon, you come in here and explain to me why you want to take one of the largest banks in the world out of the UK'. Now, that may not be a standard game-play, but it's one hell of a response to being pushed into a corner!" (SM1)

On a more routine level of risk monitoring, respondents noted a difference between expert cultures of the FSA and the banks regarding which risks are significant, sometimes translating into the regulator's lack of resources, or apparent will, to enforce a new rule. As C15 sees it:

“Regulators actually do understand that gaming of the rules goes on. Within the FSA there’s a constant discussion about how to train their people, or get people in who understand where gaming’s going to occur. Though it’s not generally articulated in those terms – it’s articulated as ‘how can we get the people in that will understand what this business is doing’!” (C15)

Such “expectation gaps” were widely perceived and may be seen as a normal risk attaching to any regulatory attempt to deploy a system of control (as predicted by Goffman, 1974; Kaplan, 2008). Some examples of banks’ strategies for resisting the regulator’s questions are provided in the sections following.

5.3.2 Demand management: Exerting control of intellectual property (risk models, products) and data production

CROs described being willing to mount a technical challenge to the regulator based on the bank’s use of proprietary risk models. Bankers’ selective use of risk models and data was seen by CROs – and indeed the FSA – as a major area of uncertainty, making banks vulnerable both to local manipulation and to wider market shocks. C25 admitted to one form of “risk model abuse”:

“Sure, we do stress testing, but what a lot of people actually do is run the tests until they get the numbers they wanted to see.”
(C25)

It was also common practice, according to respondents, for bankers to select a different risk model for each new product based on how well the risk model supported the product’s expected profit margin, and regardless of whether this represents a balanced analysis of product risk. Even when a risk model was conceptually valid, its validity might be compromised by misapplying it to an irrelevant product. Bias in selection of a risk model might be compounded by marketing staff’s tendency to “cherry-pick” data when running the model. Some, including C3, rationalised “marketing support” as not necessarily a risky, or even unwelcome activity for a CRO to join in:

“The creative-interpretative side of my job is the most interesting part, is what I enjoy most. As a CRO I’m absolutely here to reconcile compliance needs with marketing needs.” (C3)

Models were also ruthlessly deployed in response to regulators’ requests for specific types of information, ignoring wider concerns of whether they were measuring the appropriate categories of risk. The models, said C34, were chosen to

“satisfy the regulator’s evidence requirements rather than address the actual elements of risk.” (C34)

Respondents were convinced almost unanimously (with the notable exception of C14, a dedicated econometrician) that the most significant precondition for a market storm was traders’ tendency to seek false comfort by producing econometric models and tests, even though they knew that test results were sometimes derived from selectively gathered data. C12 offered a striking analogy:

“The banking industry’s biggest problem has been belief in their risk assessment and management system. Bankers basically had this comforting myth that you can just kind of stick a ‘risk probe’ into any project, like checking a turkey in the oven.” (C12)

In the present research, most CROs self-critically questioned the nature of model-based rules, and modelling assumptions. Many supported this view with examples of personal experience of situations where risk-modelled assumptions had to be called into question. Many also questioned a broad assumption implicit in the use of quantised risk models, which could be summarised as: Why would any policy designer expect model-based rules to be effective in holding institutions to public account, when the regulated community itself selects both the risk models and the data that populates them? C12 described how risk analysts developed “twenty-twenty hindsight” after a crisis. Similarly, C20 concluded that “so often the simple questions weren’t asked because they were hidden by metrics”; and C12 expands upon the conceptual problem:

“Saying ‘this is what our probabilistic risk model tells us’ of course concealed the actual situation, which was about unknowns, or known

unknowns. Models give a great view of the overall shape of results, but no assigned probabilities that would help you for example with timing of any specific occurrence. Stress testing gives you no indication of what actually happens. We have to do more to improve our understanding of incomplete information, of uncertainty.” (C12)

C12 concluded that a bank such as his could (and in the event, did) fail because its risk models were simply incapable of capturing real-world uncertainty. These experiences validate theorists’ warnings that risk models should never be regarded as “truth-generating machines”, either by regulators or practitioners: even if a regulatory process demands “*the answer*”, all that a risk model can be expected to do is show a simplified version of a system or relationship – but never “fundamentally represent” it (all phrases from Holmes and Graham, 2009, p161).

Respondents were concerned not just that the “flexible use of risk models” (C27’s phrase) came to compromise risk reporting on single transactions, but that other, related forms of manipulated risk reporting ultimately came together with models abuse to destabilise the whole banking market. For example, as directly corroborated by several respondents’ experiences (C4, C12, C20, C27, C34), a common failing was for risk data to be aggregated into a model which reported figures at Group level within the bank, so concealing some significant risk exposures at divisional level. Thus the bank’s reported view of acceptable risk might have “lost some vital perspective”, noted C4, albeit one which “FSA case officers were unqualified to advise on” (C4).

One dissenter from this view, C14, should be acknowledged, as he represents an alternative rationale that this researcher has heard widely expressed in the sector and which many bankers still subscribe to. In a notably circular argument C14, an econometrician, interpreted the 2008 crisis not as destroying risk-model assumptions, but rather as presenting an opportunity to further refine them:

“Our methodologies work as well as they’re designed to. We need to, like, go back, check the assumptions and refine the models. I wouldn’t say the stress-testing model is dead, it just needs some freshening up.” (C14)

All other respondents to the present research – and indeed HM Government’s own subsequent review (Turner 2009b) – argued that regulatory controls failed when bankers clung to the belief at sector level, until it was demonstrably too late, that all model-derived control systems worked as they were designed to. In C4’s analysis:

“You’ll never get to systemic risk by somehow going to each of the banks and trying to get the picture. You can’t see the system at a component level. You’ve got to go to all of them together and call on them to face up to a systemic problem.” (C4)

Many observed that it is unhelpful to blame risk models themselves for the abusive uses to which some were put:

“Much of the risk modelling requirements are driven by compliance in the minds of the risk team, and are not much discussed around the business.” (C6)

Nor should a model be held to blame for being the carrier of corrupt data, as C27 admits:

“It’s easy enough to play with stress tests, you can run lots and lots of them, then report the best numbers. The regulator is happy of course because you can say you’ve done lots of runs of the test!” (C27)

Thus, risk models may rest on sound assumptions, which have been overlooked or misapplied in the pursuit of profit; or may be used to carry data which has been manipulated and placed within them to give the appearance of an acceptable risk decision-making process. More than one respondent has suggested that senior managers may have knowingly engaged in combining or re-presenting risk data in ways which, though meaningless for practical commercial purposes, gave the appearance to the regulator of coherent risk metrics. As noted by C20, CRO of a bank that subsequently failed, such risk management “philosophies” of presentation were “themselves very serious risks”.

A concern on the regulatory demand-side was that the regulator was narrowly defining models in order to exclude having to think about wider questions of risk exposure. FSA prescribed risk reports were

“normally carried out at a senior level and using simplistic (and potentially misleading) top down approaches. As the FSA process is highly prescriptive - I assume as they want to standardise the results across banks - the top down nature of these rules means that we can generate almost any result.” (C27)

5.3.3 “Bargaining down” (and bulking up) the quantity of reporting to be delivered

Another significant subset of responses to the regulator’s information demands is to negotiate over what data is really necessary to report. This commonly takes the form of “bargaining down” the amount or quality of data required.

As Rothstein’s (2002) analysis leads us to expect, a new regulator with stretched resources may itself welcome ways to limit the defined scope of its own task. CROs recognise this structural tension for the regulator’s case officers and, as C20 suggests, are content to play up to this:

“There’s a certain amount of pressure on FSA operational teams not to up the ante, meaning that ‘trouble making’ is suppressed. Strong challenge is not encouraged either within the bank or the regulator.” (C20)

An alternative is to submit, sometimes voluntarily, large volumes of reporting information to the regulator such that there is more data than the regulator can reasonably be expected to review, or even comprehend:

“There can be a game of quality-versus-quantity going on in some bank boardrooms. Some banks defensively file billions of, for example ‘suspicious activity’ reports... Other banks say, you know, we’re going to be very [sparing], we’re only going to give high quality reports, not just churn numbers to make it look good.” (C18)

C18 also accepted that the CRO role enables understanding, and participation in mediating, strategies of necessary adjustment played by regulatory staff as well as the banks. The regulator, too, was seen to want to restrict the amount of work necessary, to “stave off government interference in how they did their business” (C18).

Some respondents noted with approval that FSA case staff are themselves willing to keep matters simple by avoiding asking too many questions. All accepted that the FSA needs to inform itself about products and markets and that practitioners must be the source of such briefings. Whilst routine transaction reporting is accepted, duplicated demands for information or demands for extra detail are regarded by, for example, SM1 as “disturbing the neutrality of the risk dialogue”.

There is another self-serving rationale for minimal reporting of any concerns. It could be potentially self-incriminating to share with the regulator what were initially private concerns about anomalies. Several respondents reported instances of their risk management staff who had raised concerns with the regulator, only to find their information subsequently used by case officers to attack the bank. Some banks used this concern to justify a response policy of erring on the side of being uninformative, rather than volunteering data. This is justified by SM1, who as a business head recalls the regulator pre-emptively raising the issue:

“The regulator may sometimes need to say to you; ‘I wish you hadn’t raised this topic with me; it would have been all right if I’d never needed to sign off on it but now because you’ve told me about it I can’t deny that I know, so it’s too late.’ A ridiculous conversation, but that’s the issue” (SM1)

This scenario tends to confirm McGoeys’s (2007) observations that all parties in self-regulatory systems may have a conscious awareness of the value of “strategic ignorance”. Broadly, for every CRO willing to volunteer concerns to the FSA and expose themselves to possible investigation, another would advise

withholding information – at least pending further internal inquiries – to limit their exposure to the perceived risk of aggressive enforcement action.

The regulator's susceptibility to "bargaining" was understood by many to be not merely a product of time constraint, but also necessitated by the regulator's frequent changes of staff. This aspect of resource constraint is now considered separately.

5.3.4 Exploiting the "revolving door"

Respondents justified their employer's limiting of organizational resources for compliance, on grounds of time and cost management. A bank's own lack of time or personnel was cited to justify applying pressure back onto the regulator's case officers to try to reduce the quantity of reporting required; or to use lower-cost resources, such as junior staff, to fulfil it.

The regulator's own resources are, however, even more constrained and the banks are aware that this presents an opportunity to press for a regulatory "control bargain" (in Hood's [2002] phrase). As previously noted, a regime of enforced self-regulation requires the regulator's staff to rely on the industry to provide data and to validate risk management concepts. Over time, practitioners come to perceive regulators as always "a few steps behind us". Perceptions of case officers' limited competence become self-reinforcing; one experience of incompetence primes bankers to expect further instances. An experience described by C4, typical of many, supports a common perception that the regulator's internal communication is ineffective, resulting in repeated demands for the same information. This repetition is a form of conditioning which was seen over time to desensitise bank staff:

"They [FSA] asked three times for the same transaction data. Now the more of that there is, the more people shut down their engagement [with the regulator]. It's not done in some conscious way, it's just because people get too busy, get swamped with compliance demands. So, over time, compliance requirements degrade in people's minds – it's just a process, just a piece of paper that doesn't mean anything." (C4)

Many CROs observed, and regretted as a systemic vulnerability, that the FSA's case officers were unlikely to stay in post long enough to develop a good working relationship with their bank's compliance staff. From among many examples, here is C26, who also draws his own conclusion:

“So we went all through this process (with the FSA case officer) of ‘this is the money we’re going to spend, this is what control we’re going to build, this is how long it’s going to take us’. As promised we went back to them with a progress update six weeks later, only to be met by someone I hadn’t seen the first time, informing me that the first person I’d met was a complete blithering idiot and had no idea, how could we possibly deliver that, and ‘no we don’t accept your model at all’.” (C26)

Bankers noticed high levels of staff turnover at the FSA and were willing to exploit this for information advantage. One manifestation of this (as in the cases of both Northern Rock and HBOS, see Annex 4) was to take any opportunity to defer giving concrete answers or data in anticipation of a change of case officer – described by C4 and others as a “revolving door” effect. Stalling in this way was planned to have the effect of making a regulatory demand go away. Respondents spoke, typically with a grin, about managing to defer some demand from the regulator until the problem vanished with the person. This outcome was regarded as a success for the firm and for the office of CRO; as a saving of resources.

A variant on the “revolving door” tactic was to stall by deploying the consultative process itself to raise counter-queries. C24 offered an example:

“Because of the bank’s offshore business, they were asked by the FSA to complete a Section 166 report – the FSA wanted to check that the bank was properly managing and documenting its arrangements for governance, continuity planning and security across its sprawling empire. The bank took months negotiating with the FSA the scope of the review; it was a battle of attrition with the FSA all through the scoping phase, just to keep reducing the scope. In the end it came to a point where the original Section 166 demand became unnecessary – it was almost as if the FSA forgot what all the fuss was about!” (C24)

It would be unfair to characterise CROs as generally enjoying such opportunities to exploit the FSA's staffing system. Most CROs expressed regret or frustration, rather than opportunism, in response to the event of rapid staff turnover.

Before 2008, many bankers had chosen to interpret the FSA's light-touch regime as an endorsement of the commercial view that inspection demands could be negotiated away or simply deferred pending a change of case officer. As the FSA itself later admitted (Turner 2009b), in the cases of Northern Rock and HBOS, frequent changes in case staff had indeed blinded the regulator to the seriousness of some problems.

5.3.5 Redefining compliance: the manipulation of regulatory capital reports

More than one respondent referred to the industry's history of low regard for the compliance process; "my colleagues often refer to compliance as 'a brake' on ingenuity" (C12). Other less polite phrases are also used to indicate that regulators frustrate trading.

All respondents were asked for their broad view of the extent to which regulation may or may not be burdensome; whether the compliance task imposed was a reasonable one. C2 shares the clear consensus that, before the market crash at least, the burden does not justify the benefit:

"The amount of time it takes us to 'be regulated' – for us to deal with the people who are regulating us – increased dramatically over the past three years (to 2007)" (C2)

C2 and others (C4, C18) suggested that undue cost is seen as a reason to challenge regulatory legitimacy. Some respondents suggested that any increase in detailed rules meant that the regulators were making work for themselves, implying: the more rules, the less compliance. While CROs said that they understood that coping was clearly not the response the regulator intended, it was still a logical response. As C27 said, in corporate terms it was "the expected thing to do":

“With so many new rules it is not surprising that CROs focus on ticking boxes rather than ensuring proper self-assessment of risk. The focus is on meeting regulators’ demands, with no concern as to whether these improved risk management or not.” (C27)

C34 concurred:

“Controls were developed with a view to satisfying the regulator’s evidence requirements rather than addressing actual elements of risk.” (C34)

In terms of the impact of all this on practical reporting to the regulator, one risk construct most commonly referred to as “playable” was the definition and calculation of regulatory capital. As every respondent confirmed, banks hated to tie up in-house any capital which could be, as they would see it, better used in the markets. Regulatory capital was, in these terms, money which the regulator was telling the bank it was not allowed to use in any way except to hold on account against the chance of a transaction going bad. Bankers universally saw this as a form of (costly) self-insurance. C27 said that it was “standard reporting” for a CRO to compile a self-assessed regulatory capital figure and that

“despite, or perhaps because of, the volumes of text in the regulatory guidelines, each bank seems to have a different approach. Lately (post-2008) as the regulator is trying to get all lenders to use the same, simplistic, ‘slotting’ approach, so there is a lot of gaming going on, each bank trying to get as many loans as it can arbitrarily defined as ‘good’ so as to attract the least amount of capital (requirement).” (C27)

Although there were, and still are, rules as to the margin of regulatory capital required, the actual regulatory capital figure that a bank reports is in practice a matter of negotiation between the CRO and the regulator. The regulator wants a higher figure, as better insurance against bank failure; the bank wants a lower one, so that less of its funds lie idle.

For many a CRO, therefore, situated in the middle of this negotiation, a defining feature of their employment has been the pressure to reduce regulatory capital. As C11 recounted, a CRO could quickly become popular among colleagues by

concentrating on reducing their employer's costs of regulatory capital – that is, by estimating a lower figure and presenting this to the regulator as fact. Careful, and indeed selective, interpretation of rules and definitions was the key, said C11:

“As it was a major bank, I managed to find £12billion of regulatory capital to release within six months there, mainly by ‘playing’ the rulebook. The Board said it was an excellent return on the cost of hiring me!” (C11)

Some respondents referred to this as evidence of a wider, so-called Goodhart Effect²⁶ encouraging traders to report compliance in the narrowest possible terms, whilst otherwise continuing “business as usual”, with behaviour unchanged. Two respondents offered an analogy for how this works in practice. First C12:

“The fact that you’re using something changes it, so a risk indicator will affect the thing it’s indicating. You know, if you’re hitting something with a stick, the stick changes shape.”
(C12)

This perception recalls the “Goodhart effect” (noted in Chapter 3), that the act of being measured changes the behaviour of the people who are measured; and also Mackenzie’s (2008) thesis, developed from Friedman, that risk models act as “an engine, not a camera”.

C35 reads the situation as a plain matter of quantity of supply and demand:

“More regulation simply opens up room for more arbitrage. There are just so many smart people out there!”
(C35)

A related point concerns systemic skew of incentives: within most banks, compliance activity is structurally arranged and accounted for as a cost centre.

²⁶ After Charles Goodhart, LSE Professor and former Bank of England Monetary Policy Committee member, who proposed “Goodhart’s Law” of regulatory design failure: “that when an indicator is made a target for the purpose of policy, it loses the information content which qualified it as a target in the first place”

One simple indicator of the bank's good intentions (or otherwise) for compliance is the level of resources that the bank chooses to make available to support compliance activity. As a qualified lawyer and veteran of several compliance departments, C18 suggested that there is an easy way to measure how seriously a bank takes its duty to compile compliance reports:

“It's easy to tell how much real power any bank's compliance function has – just see how much budget it gets. That's the Finance Department's way of saying ‘we're prepared to give only this much resource to this activity’” (C18)

Whilst generally well-intended, CROs' responses to FSA requests for information are often attenuated by concerns about resource implications and the degree of perceived need.

A further type of manipulation concerns how the CRO deploys staff to present the requested information to the regulatory case officer. Examples of this are now considered.

5.3.6 Presentational strategy: Stage-managing the regulator's access

Three CROs described a strategy of carefully organizing a physical process of how they presented their staff and information to the regulator (C29 calling this “stage management”). This may be seen as a conscious effort to lower the intensity of any dialogue with the regulator, by orchestrating how it is played out. C29 said that it gave him “some amusement” to arrange case-officer interview appointments in a sequence ensuring that his “dullest” staff members “get plenty of face time first”; multiple members of the compliance team could be deployed to meet case officers so as to “bore them to distraction”. Several other respondents described deliberately fielding junior staff to talk to the FSA, as a similarly attritional strategy.

C6 rationalised a “stage management” strategy as a matter of plain practicality for both sides:

“You know they [case officers] have got to write something, so you’re happy if they find a couple of things. And you may, you know, point them in certain directions – you know, make sure you control who’s in the room and who’s having a conversation with them, that they sit with that person, this compliance guy, this risk guy is to sit next to them.” (C6)

C26 is equally frank about deploying this strategy, even telling the regulator that it is happening:

“I always tell our case officers ‘you can have access to anyone you like but you need to go through me’. You [meaning I] co-ordinate it. You can’t block it but you can control it, steer it, and usually in the main they will sort of give in to being manipulated, because it just goes with the territory, or they don’t see it, or they choose not to see it. You make a character judgement of your case officer and then against that reading of them you arrange how your staff engage with them.” (C26)

5.3.7 Presentational strategy: “blinding with science”

The quality of the regulator’s staff was widely regarded as a significant point of risk control weakness. C15 offered a stereotypical view of senior FSA managers is as technocrats, remote from trading activity:

“The FSA had very much bought into a simplistic, black-and-white, even ivory tower approach that what businesses were able to do... bizarrely it was almost blind them with science. We say ‘actually you’re not very close to what’s happening in the real world, you know things have moved on very quickly, you need to understand the commercial realities we’re facing’.” (C15)

Though they were not so remote from the trading floor, junior and case-officer staff were commonly perceived as not being competent to handle the task required. A common presentational tactic responding to this perception, said C15, was to call their bluff; to “blind the case officer with science” on the basis that they will either pretend to understand, or be “too embarrassed to ask the same question more than once or twice” (C15).

CROs also noted that their banking colleagues were accustomed to keep case officers at arm's length by using jargon terms to perpetuate a culture of expertise. They saw this as a strategy of forcibly creating social distance between banker and regulator as a way to establish and emphasise case officers' self-perception of inferior status in any dialogue. C26 offer the – highly contentious – argument that regulatory staffs' perceived low status is a reflection of inferior rewards:

“What you learn is, the reality with every regulator inevitably because of the compensation they pay, is that they're often less competent than the people they're trying to regulate.”

(C26)

This also suggests that case officers and CROs are conscious of one another's perceived status as, respectively, unwelcome visitor and cost-centre employee. Conversations with visiting case officers are seen as potentially uncomfortable. Respondents rationalise this discomfort as resulting from case officers' simple incomprehension of the business or product, compounded by staff turnover which exacerbates lapses in knowledge. Encountering “a whole new team” of regulatory cases officers, a CRO may regard them as “learning at our expense” (C26). In such circumstances the CRO might readily conclude that the need to repeat explanations limits the possibility of raising any genuine concerns, let alone whistle-blowing in the event of serious concerns. Respondents also recognise that insensitive handling of these issues in face-to-face meetings with the regulator might amplify the damage if case officers then chose to pursue a tough prosecution.

Respondents remarked on various relevant factors contributing to the low perceived status of regulatory staff, including their inexperience, poor compensation, and lack of an authoritative presence. These perceptions encouraged a form of instrumental conditioning among compliance staff; expectations were lowered to the point where banks did not expect case officers to comprehend, or act upon, emerging problems at a strategic level of risk, as C4 noted:

“It’s all very well the bank reporting formal risk breaches and stuff, but few of the FSA case officers are experienced enough to realise that sometimes it’s more a case of – ‘do you know, this is a business that you guys really shouldn’t be in’.” (C4)

Risk Office’s production of papers for the regulator could also be stage-managed to some extent. CROs did not always regard production of “audit trail” documents as time wasted; sometimes this process could itself form part of an alternative strategy for disengagement. An alert CRO could see that the regulatory burden might, paradoxically, be reduced by increasing the amount of paperwork volunteered to the regulator, so as to preoccupy them. C18, for example, watched colleagues use the tactic of “keeping the regulator busy” by voluntary and pre-emptive filing of a large volume of reports “just to look like they were really doing their homework right” (C18). This response is a creative alternative to seeking to reduce the regulatory burden by negotiation – “bargaining it down”.

5.3.8 Selective presentation of credentials

The regulator could ask bank staff to explain any activity they were engaged in, under the “comply or explain” rule, one manifestation of the “light touch” regime. This request could be either pre-emptive or retrospective. Routine, pre-emptive gathering of information by the FSA was accepted by CROs as a “necessary evil” or “friction cost of business” (as phrased by TA1 and C12 respectively). However, CROs broadly expressed resentment at the wasteful duplication of effort involved in filing multiple reports of transactions. This factor was seen to drive a number of identifiable forms of coping behaviour.

Responding to simple requests for information from the regulator, CROs were typically cautious about suggesting a “best practice” approach to engaging with the FSA day-to-day. Despite being tasked with upholding, in C4’s words, a “social responsibility line about always helping the regulator”, they characterised dialogue in practice as incremental; that is, taking small steps towards engaging, rather than aiming to be all-inclusive. C6 described a strategy of being helpful but not too helpful, of responding without taking any initiative:

“Less is more, in terms of information provided. Let (FSA) find their way to the information. If a question is asked, answer the question, but maybe don’t broaden it up if you don’t need to.”
(C6)

A variant of this was to “push and push back”, according to C26, reflecting a common perception that people “disengage” when the regulator is seen to be “intervening too much” (C4).

These views should be balanced by the observation that most respondents said that their banks would prefer to avoid impasses by showing the regulator that they were already taking reasonable precautions. C32 indicated that there were various ways to give the regulator a clear sign of good intentions in routine compliance practices:

“Some sensible procedures are obvious to do – such as having senior officers sign off on drawdown.”
(C32)

However, most respondents resented the inroads made by regulatory demands into commercial time – or, more significantly, they resented having to justify making demands on their front-office colleagues’ time. Even the CRO of a “good bank”, such as C2, could be critical of the FSA for demanding too much information and then apparently not using it:

“The FSA routinely demands trading activity reports which duplicate information we have already given them. It’s not unusual to be asked three times by three different [FSA] people for the same set of transaction details. We know for a fact that this information the FSA gets is not used by them. A huge (transaction) database sits at Canary Wharf but the FSA hardly looks at it.” (C2)

This resonates with others’ experiences of doing their best to comply, only to find that the regulator’s response to their response was not what they might have been expecting. C2, again, sums this up:

“So they self-disclosed (to the FSA), then next thing you know they’ve got a big fine and been sanctioned. That’s not necessarily the right message (for the FSA) to be sending to the market, it makes it difficult for people to be open and honest with the regulator if they know they’re going to end up with a big fine and lots of adverse publicity.” (C2)

CROs’ experiences of interaction with the FSA, often contradicting expectations, have been considered; the following section reviews these findings to conclude on the efficacy of engagement between the two sides.

5.4 Conclusion: Was the regulator perceived to be effective? Did the CRO engage?

Out of these interviews a picture begins to emerge of a new and extreme form of disengagement with the regulator. This phenomenon, which will here be described by the phrase “beyond capture”, is a potentially significant finding which will be returned to in Chapter 7, where CROs’ experiences in the Boardroom are reviewed, and in the Conclusions in Chapter 8. In an informal summary offered by C12, the “beyond capture” phenomenon may be said to have arisen

“not because banks are Too Big To Fail; it’s more that they are Too Big To Care” (C12)

“Beyond capture” is the outcome which may be predicted to occur when a self-regulatory supervisor tries (and fails) to achieve meaningful engagement with a sales-driven and massively-resourced commercial sector with an overwhelming belief in the supremacy of its own informal business culture.

At a routine level, respondents reported seeing signs of internal tensions within FSA itself regarding the practical shortcomings of light-touch, as opposed to granular or detailed information-gathering. On a related point, many CROs also offered the view that Turner’s (2009b) review of the crisis was flawed because it concentrated on regulatory control systems whilst offering no practical

suggestions for tackling the more urgent issue of banks' cultures of compliance (considered further in the chapter 6).

The evidence supports a finding that, even before the 2008 crash, CROs were wary of the optimistic policy rationale that self-regulation works because markets will allocate resources according to profitability. Regulatory compliance was seen by banks as a cost to be suppressed. There was some concern that regulatory policy was naïve in assuming that traders would ever take into account the public good – even in the narrowest sense of any concern for a viable long-term market. In practice, said CROs, banks regarded short-term profit as routinely dominating all other concerns.

In this regard, C4 was nostalgic for the regime of the recent past (pre 1997) in which there was a well-established way to stop dangerous opportunism; having a regulator whose personal authority bankers would respect.

“In the days before the FSA, if you were called up in front of Eddie George [Governor of the Bank of England] it really meant something, public shaming, it used to hurt, the whole world knew your business and it would be frowned upon.” (C4)

Although in the (1977 - 2009) “light touch” regime dialogue with the regulator was welcome, there was seen to be a danger in sharing private concerns with a regulator who might return to use these confidences as the basis for a public prosecution. However, simple enforcement was not seen as the better alternative, as C3 said:

“Regulation by enforcement, I’m not a big fan of it. If you cannot come clean about a failure you have identified – and certainly that can be a very dangerous thing to do – then the relationship with the regulator gets a bit tricky.” (C3)

Respondents with experience of enforcement in different jurisdictions, notably the US, perceived marked differences in the impact of regulatory enforcement on personal attitudes. Two widely admired exemplars were reported to be the ‘old’ Bank of England under Governor Eddie George in the 1990s, whose ability to

‘look you in the eye’ was seen as a great asset to orderly market making; and the no-nonsense approach of the US market regulator, the SEC, as C4 recalls:

“the [US] Department of Justice comes into the bank with the guns and the handcuffs, and massive fines... when you’ve seen the Feds coming in with handcuffs and a gun and marching someone away, it’s terrifying, that sticks in people’s minds and it gets around the marketplace. But the [UK] principles-based approach is a much, much easier game to play against... the FSA just has to put its trust in an awful lot of people.” (C4)

One might, then, have expected to find CROs supporting the notion (after Sparrow, 2000) that government produces new rules performatively – that is, producing symbolic expressions of power rather than real instruments of control over a sector. CROs and their firms did perceive a systemic weakness in regulatory policy and design; they knew but do not publicly acknowledge that the validity of risk models rests on flawed assumptions, and that enforced self-regulation with its light-touch and principles-based approach also relies on the same assumptions. However, if respondents did perceive the regulator as engaging in symbolic acts, such as levying a big fine against a well-known brand, they interpreted this as an acceptable move within a mutual “game” of regulation in which coping responses are legitimate on either side:

“Oh yes, of course when [bank name] were fined, it was just their turn to be made an example of – it may be ours next – that’s what the FSA has to do to show it’s doing something. ‘Buggins’s Turn’.” (C24)

Another fallacy of financial regulation recognised by respondents was that it may justify itself on grounds of evidence-based rationality, even though financial markets should not be expected to act rationally. As C12, an investment bank CRO and self-confessed “casino supporter”, put this, the regulator makes too optimistic an assumption :

“The trouble with principles-based regulation is that there are parts of the market that are not very principled.” (C12)

The underlying question is more one of business ethics than regulation for its own sake: Did bankers support the system out of genuine commitment to its values, or out of expediency? On a related point, were gaps in the regulatory

framework respected or seen as fair game for creating profit opportunities? As a veteran of two post-crash bank rescues, C24 offered this outlook on what was wrong and needed to change:

“[The old] regulatory complexity was self-defeating... a spiral of ever-increasing product and risk complexity being chased by ever-increasing regulation. Banks loved it because the more complex the rules the easier they are to bend and exploit. Better, now, to simplify the [regulatory] code to core rules and measures designed to make the whole industry transparent even to lay people.”
(C24)

Although respondents offered many, often colourful examples of subversive conduct, it would be misleading to draw from these incidents a general conclusion that all CROs were actively complicit in subverting the regulator’s information gathering. Most remained diligent in fulfilling routine reporting requirements where there was little room for manoeuvre.

Rather, these incidents begin to bring into focus a notion that CROs draw upon a range of partially-compliant responses. This range varied with individual CRO and may be informed by the individual’s response to the culture of the employer organization. Some described their response as “making sense” of sometimes conflicting or incomplete information about risk and compliance expectations. This recalls the idea of sense-making as suggested by Karl Weick (1995); that is, of a private attempt to complete an unclearly defined task by filling in the gaps between known instructions. With some consistency emerging in these narrated accounts of coping responses, it is now possible to begin to group certain attitudes thematically.

The CRO’s personal response to the employer culture might take one of several defined directions according to whether he/she regards the employer as a “good”, “bad” or “muddling” bank. In a good bank, a CRO was unlikely to find troubling behaviour, as the prevailing culture was of “doing the right thing”, including early and voluntary disclosure of any compliance concerns. But CROs in “bad” or “muddling” banks, that is, banks which failed, said they faced a difficult choice. They may have passively acquiesced with the bank’s resistance

to the regulator (whilst hoping that no major incidents occur during their term in office); or they may have actively engaged in resistance; or they may have objected to the manipulation of risk reporting, and suffered the consequences.

The reality of that choice might vary from day to day and meeting to meeting. The overriding profit motive, gross asymmetries in reward and perceived status between sales and back-office, and simple self-preservation often produced a culture in which minimally informing, bargaining or gaming against the case officer was regarded as an appropriate response to an information request. Most respondents were content to use the word “game” to describe this in the privacy of the interview. However, it is telling that an apparent taboo on acknowledging the existence of such a game began to lift after the event of a market crisis had forced participants to reconsider it:

“So yes, I hear a question now that you didn’t hear so much in the past, it’s sort of: ‘OK, so that’s what the regulators say; but how much do we care? How much do we feel we actually have to along with that?’” (SM1)

SM1, who in addition to Risk Office duties headed a business within the bank, also discussed how regulatory engagement was missing from new product development. He acknowledged that the time pressure to bring a new product to market is a key issue in compliance, noting a cultural “history lesson” in the sector: as regulators tend to be “miles behind us”, it is rational to rush products into the market - the regulator “will catch up with us eventually but not just yet’.” (SM1)

This asymmetry of timescales was a generally acknowledged control problem. The conventions of company financial reporting to shareholders (Power’s 2004 “audit rituals”) were seen as irrelevant because of their focus on quarterly or annual timeframes; by contrast many banking products operate either on a very fast (minutes), or very long (decades) timescale. Short-termism is a related concern, with C16 offering a plain account of how this major control asymmetry supported abuse by sales people – highlighting bankers’ own limited job tenure as the critical point of weakness:

“Anyway, how do you regulate something with very long-term effects, that may create a risk or loss long after the people who thought of it are retired and putting their feet up in Barbados?”
(C16)

As noted in Chapter 3, researchers have already observed the existence of a conceptual gap between those who produce regulation, and those who are “consumers” of it (regulatory agencies and regulated actors). In the present research, policymakers were seen still to be assuming that the act of producing a regulation itself exerts some power over the community that is to be regulated. Respondents suggested that this belief may have followed on from an assumed, but defunct, rationale of conventional command-and-control; that is, that what matters most to the regulatory bureaucracy is the act of creating a framework to acknowledge the presence of risk (Seddon, 2003). A regulatory instrument may not support decisions on practical engagement with risk, although it may of course influence them; such decisions are left to the discretion of the regulatory agency tasked with day-to-day control. CROs perceived emphasis on “abstractions” of risk (Seddon, 2008) rather than any practical objective of “genuine engagement” with what regulatees actually do (Macrae, 2009). C6 was unconvinced by the FSA’s occasional attempts to overcome abstract rules by attaching itself to banks’ commercial initiatives:

“What we quite frequently see is the regulator basically trying to assess where the herd is and then taking the leading point as the control. So, say the regulator perceives you (as a bank) as being good at doing something, they will take that as a model and push that around other companies. They’ll sort of say ‘that’s how company A does it, how do you do in comparison with that?’.”
(C6)

C6 also suggested why this may be a naïve strategy for a regulator to adopt:

“Now of course because companies A, B, C and D will talk to each other quite frequently, they’re going to realise that actually all the FSA is doing is follow the herd.” (C6)

It is reasonable to infer that, if regulatory decisions (to intervene, or not; to accept the validity of a risk model, or not) were based on “following the herd” – and that this was widely perceived by CROs to be the regulator’s strategy for (dis)engagement – bankers might conclude that they had little to fear from the FSA.

In the aftermath of the 2008 crash, there was speculation that UK financial regulation lacked legitimacy. Respondents commonly criticised the FSA, in common with other new regulatory agencies, for having a brief devised by government to be performative – that is, to express power symbolically (and so not necessarily to exert real control). Allied to this was a perception among banks that controls rested upon risk models which themselves used flawed assumptions.

Present research responses have confirmed indications from research in other sectors, that the broad efficacy of enforced self-regulation is open to question on several fronts: is it a demonstrable method for modifying behaviour, and if not, why was it ever thought to be effective in curbing powerful commercial groups? If the efficacy of self-regulation is uncertain at a strategic level, what other assumptions by regulatory policy makers are also questionable?

Enforced self-regulation may engage the attention of the regulated community but is perhaps only a ‘least worst’ way for a regulator to attempt to overcome problems of access and data. It is open to abuse by sophisticated players; and, as here seen, may even be seen by these players as a form of invitation to regulatory capture (as expected by Pearce and Tombs [1990], Sparrow [2000]).

Knowing that such early studies predict that flaws in implementation may be expected, the present research invited respondents to reflect on any practical ways that the regulator might better control errant behaviour. Despite recent critiques of the FSA’s implementation failures (Turner, 2009b), it would be misleading to characterise the respondents as generally sceptical of regulation, or indeed as having a non-compliant attitude. Rather, CROs saw themselves as struggling to reconcile ethical intent with commercial pressure for profit.

The commonly declared intention, however, remained technical compliance with the minimum of adjustment, to “help find ways around regulation” (C26).

Such attitudes raise the question of how well regulation, as drafted, functions when faced with the reality of a room full of bank traders. A recurring theme in conversations with respondents was that a rule may be technically correct but fail in practice because it takes no account of factors that motivate traders – ‘tribal’ loyalties following informal organizational cultures, heuristics, and affect. Respondents derided the argument that regulation should work because it has a rational value system – this is seen as a bureaucrat’s misconception of how commercial organizations engage with market realities. As the “meat in the sandwich” (between commerce and governance) (C12), the CRO had to reconcile the gap between risk assessment rationalities and sales staff behaviour (influenced by affective factors such as fear or exuberance). This raises the question of how effectively the CRO was able to engage with the bank’s traders, which is addressed in the following chapter.

CROs appear to be suggesting that market shocks are a natural product of flawed regulatory policy assumptions, typically as to risk modelling (Merton’s [1936] “unanticipated consequences” of the regulatory enterprise). The following two chapters will review an alternative frame, that the engagement with the regulator is based on collusive trading of “knowing ignorance” (McGoey, 2007), a form of “Game of No Game” (Cohen, 2001). (The schedule of interview questions recognised this possibility, asking whether CROs might perceive such factors at work, either privately or emerging from dialogue with the regulator’s case officers.)

CROs’ reported experiences of day-to-day encounters with the regulator, whilst not individually significant, when taken all together amount to a larger suggestion: That it is time to change how we view banks’ strategic engagement with regulator. The past concept of “regulatory capture” now no longer seems sufficient to describe how completely controls fail in the practical context of a

vigorous commercial market. Present findings suggest that a new notion of capture is needed; this notion will be developed in Chapter 8.

CROs indicated that bankers see the function of regulation as not to try to improve behaviour but merely to install a control mechanism which may be pointed to for reassurance whenever public doubts arise. As expected, this echoes studies in other regulated sectors which found such perceptions to be preconditions for various forms of partial compliance – ranging from the quasi-compliance of “ritual audit” (Power2006) to more aggressive forms of coping strategies played against enforcers (such as Hood’s “control bargains and cheating” [2002]; or Bloor and Samson’s “market-fixing activities” [2009]).

Banks, as seen (and of course represented) by CROs, appeared to care little that outsiders regard their staff as selfish opportunists. Yet it would be dangerous to assume that the banking sector is entirely driven by selfish opportunism. CROs perceived a “public good” component of regulation as being fulfilled by a two-stage process, with regulation as a game played with a commercial first round, kept in check by a regulatory second round of catch-up, after some time lag:

“The way that wholesale financial markets work is simply that the real margin of profit is to be made out of instruments which are brand new, before they become commoditised. So by definition they are developed before other people, including regulators, can understand them.” (C16)

Two CROs estimated this time lag as up to two years.

Although this and other tactics of “playing the grey” (C3) are widely noted by respondents, these are not seen as necessarily engaging in as a cynical manoeuvre; more as a commercially pragmatic response where an under-resourced regulator is unable to keep track of fast moving product development in an aggressive and global market. Respondents offer a common rationale that this is merely how wholesale banking markets go about their business: the essence of technical and highly mathematical banking instruments is to take advantage of uncertainties and anticipate developments by superimposing risk

value judgements. With this motivation in mind, it is appropriate here to move on to examine more closely the CRO's experience of dealing with the bank's salespeople who make these judgements.

Where this chapter has established that the regulator's demands may be "gamed", the following chapter will therefore consider the role of sales staff as a possible source of the pressure to introduce alternative coping strategies. The possible involvement of senior management as a further source of pressure will be separately considered in Chapter 7.

CHAPTER 6: CROs' RELATIONSHIPS WITH TRADERS

“Just because one has committed an infraction of a rule does not mean that others will respond as though this has happened. ...Formal rules ...may differ from those actually thought appropriate by most people.”

(Becker, 1963)

6.1 Introduction: CROs engaging with bank staff; the formal and informal organization

Where chapter 5 considered how CROs interact with the regulator, this chapter considers how CROs interact with bank staff. A CRO's relationship with bank staff may be expected to influence the tension between the CRO and the regulator observed in the previous chapter. Chapter 6 will review CROs' experiences with bank staff to consider this influence.

A particular focus of interest here is the nature of interactions between the CRO, as head of the bank's Risk Management staff, head of the entire back-office apparatus of book keeping, risk review and regulatory compliance, and traders²⁷. Traders are the group of staff that the CRO is appointed to control, yet the practical control of traders is far from straightforward. It is found to be, in practice, considerably harder than might have been expected, given the apparent authority vested in a CRO role. This chapter explores some factors which may have rendered attempts at control less effective than intended. It will question the extent to which a forceful but informal group within the organization traders in banks might influence the overall response of the organization – that is, banks' traders – towards proposed risk controls.

As found in other regulated organizations, one might expect to find banks responding to demands for compliance and greater risk control with various forms of creative coping strategy. The CRO's personal experiences of

²⁷ “Traders” is here used as a summary term to include sales, marketing and product development staff; also collectively known as the “front office”.

compliance responses among sales staff indicate how their employer organization defines its engagement with regulation in practice.

Negotiations about compliance occur between regulator and CRO (as seen in Chapter 5) and also between traders and compliance staff. Regulators are seen as open to negotiation, with the chance to strike a control bargain. Traders and CROs might be expected to perceive that the regulator is vulnerably dependent on such negotiations; this chapter will report whether this was found to be the case.

6.2 CROs negotiating traders' compliance: What is supposed to happen?

Before examining the evidence of what occurs in practice, it is useful to consider briefly how the CRO's requests to traders may be expected to work. Any deviations from the expected process may then be more readily apparent.

As the controller of the bank's public reports of risk exposures, the CRO has a direct interest in encouraging traders to adopt best practice in risk management, such as by adhering to agreed exposure limits, or raising early any concerns about unexpected product performance. The CRO may reasonably expect to ask traders to produce risk information supporting these aims. Some examples of relevant information requests follow.

6.2.1 What information can the CRO ask traders to produce?

Summarised from CROs' own broadly consistent descriptions of their work, this subsection outlines how a CRO and a trader are intended to interact in the normal course of business; the remainder of this chapter will then report and review actual interactions.

The CRO expects to receive from traders, and is authorised to ask them for, routine information about the bank's exposure in terms of its trading positions

and products. At its simplest, this is information about the value and volumes of trades (sales) undertaken and the structures of the financial instruments traded.

At a higher level, the CRO is also tasked with overseeing, and is expected by the Board and the FSA to be instrumental in setting, monetary and risk limits on trading. In discussion with the bank's Finance department and the heads of trading desks, the CRO may determine on the bank's behalf how much risk is acceptable to have tied up in any one product or trading activity. CROs seek to achieve control by setting "book limits" for each trader – that is, to limit the total monetary value of product that any one trader or desk may have contracted for in their financial market at any one time. Exceeding book limit is a potentially serious offence for a trader.

As well as such controls exerted through the bank's own management accounts, the CRO uses tools formally recognised by the regulator as appropriate for risk control. The FSA and other relevant authorities (such as the Basel global agency specifying Capital Adequacy standards) prescribe certain formats of risk test for a bank to use to show that risk-taking is at a level deemed acceptable to the public interest. Among these, most CROs (see chapter 5) refer first to the regulatory capital standard, also known as capital adequacy, a control specifying how much of its own money, as a proportion of its capital, the bank must hold on account as a safeguard – that is, a form of self-insurance in the event that the bank's trades incur big losses. Other compliance tools include various forms of test for risk exposure, such as stress testing, where a product is run through a series of (simulated) trades based on possible changes in trading conditions. The stress test is a "what if?" scenario designed to challenge any unsound assumptions in the product's design or sales approach. Another common form of test, trading simulation, involves running a large number of trades to see if a product's performance might deviate from the risk expectations designed into it; this form of testing (known as "Monte Carlo" analysis) is based on the assumption that simply increasing the volume of trading will help to flush out any points of weakness.

Traders are familiar with these forms of statutory test and with requests to provide routine trading and product design information to support them. In a well-governed bank the CRO might reasonably expect traders to respond to requests for risk information by opening their trading books, or product designs, to the CRO's scrutiny.

As will be seen, in practice the pressures of trading may mean that responses will not be immediate but may still be expected in reasonable time. In the event that a CRO does not receive a compliant response, there are several options for pursuing the request for information, considered below.

6.2.2 Ordinary remedies when traders are unresponsive

Although there may be an unresolvable tension between market-making and risk-restraining actors, there may also sometimes be valid reasons why a member of staff such as a trader cannot immediately comply with a senior manager's request for risk information. The staff member may be away from their desk in a meeting, on holiday, or genuinely preoccupied with urgent business.. If, in the ordinary course of business, a trader does not respond to a CRO's information request, there are ordinary management controls which may be used to chase up the (apparent) non-compliance. First, the CRO may simply repeat the request, perhaps with an incentive to encourage a compliant response, or a threat against continued non-compliance.

If the trader continues to resist the request, or the level of information offered seems inadequate to the CRO, back office may seek other managers' support, initially from the manager of the trading team, then from senior management; typically, first, the Finance Director, then possibly also the Chief Executive. One respondent (C25) refers to this as "obtaining air cover". The CRO may also enlist general management (Board-level) support in the event that resistance to an information request seems to be a systemic problem.

Finally, in the perhaps unlikely event that the Board does not offer support, as a public reporting officer the CRO has the option – at least in theory – of calling on outside support in the form of the FSA.

As indicated by respondents, these are the formally organized options for escalating management of a problem; they are unremarkable as a set of management procedures. However, as banks may have distinctive ways of invoking and responding to these procedures in practice, the rest of this chapter will now consider factors shaping how the risk reporting system is used in reality.

6.2.3 Do structural tensions influence traders' responsiveness?

Before moving on to review specific accounts of incidents, it is relevant to note the structural factors underlying this tension. The following is a summary of the factors as respondents have characterised them.

Whilst it is certainly not news to any CRO that there is organizational tension between commercial “front office” people and compliance “back office” people in any bank, this research reveals some striking and characteristic occurrences of this tension as experienced through routine interactions. Again, all respondents saw this tension as an expected, even normal feature of working in a bank (in C15's phrase, having a “separate back office function”). This is regarded as part of the business culture of banking, informing both conversations between employees and any dialogue with the regulator. The structural factors that underpin these tensions follow.

Sales-side staff, here collectively referred to as traders, are incentivised to sell, with large cash bonuses. This conditions their approach to the job to the point where their prime, or even only, motivation is to make sales. CROs perceive that traders may regard any other demand on their time, such as making a compliance report, as irrelevant; harder still to try to engage a trader in a discussion about an issue which may or may not become a sensitive point with the regulator. when a colleague of C4 suggested to traders that it would be good

for relations with the regulator if they would kindly volunteer to report sales of a new product in greater detail, the suggestion was dismissed:

“They were being warned and it was ignored. He had to start lobbying, but he had real trouble making a watertight argument because it wasn’t a binary, yes-or-no thing, more just that any sensible person would have gone along with it.” (C4)

The trader’s task as an employee is defined in narrow terms as generating sales and avoiding incurring short-term trading losses. A concern expressed by several respondents (C11, C23, C27) is that the trader role is designed to exclude responsibility for costs of sales, meaning the routine running costs of the business including office overheads and, significantly, costs of regulatory compliance.

As employers, banks have thus intentionally designed the role of traders as insulated from any concerns about management costs – the intention being to focus all efforts on selling, with minimal distractions of book-keeping. One effect of this role definition is to create an informal group culture of front office employees within a bank. As described by C34, front office see themselves as “the people who sell”, and who may further define their role by what it does *not* do: any concern with “housekeeping”:

“Trading desks may fix specific bits of noncompliance but don’t make much attempt to consider why anything went wrong in the first place.” (C34)

One may regard this arrangement as a form of constructed optimism bias. This bias may be compounded by a factor which respondent CROs commonly noted: that the demands of high-stakes selling attract a certain personality profile, described variously as “assertive” (C15) or even “bullying” (C5). Moreover, CROs observed traders to attach more significance to achieving personal sales than any sense of the collective interest. In any event the “collective interest is seen not to extend beyond the trading team” (C27). Traders regard selling as “doing what the business wants” (C11); their outlook does not extend as far as the collective interests of the whole bank (employees, shareholders), nor as far as

the “orderly markets” which the regulator is required to supervise on behalf of society at large.

Instead, traders’ risk-taking is limited by more immediate and personal factors: their book limits; possible disapproval from a team leader; and fear of only one risk, short-term loss on a “bad trade”. As a result the prospect of any loss other than one arising in the current (typically three-month) reporting window is not a deterrent, as the employer bank measures traders’ success in terms of short-term volumes of product sold into the market.

Where the trader’s role may be interpreted as one of constructed optimism as it internalises the profit motive, the CRO role entails constructed pessimism. The CRO is tasked with containing risk, which includes factoring in costs of sales (for example the costs of resourcing a compliance office, and the losses incurred on any trades which lose value over any timescale longer than the short term). In marked contrast to the trader, the CRO routinely factors in and has to reflect on considerations of cost and public accountability. Where the trader is largely protected from public scrutiny, the CRO routinely has to face the Board, and the regulator, to answer for risks taken. It is self-evident that this asymmetry in personal responsibility for risks taken has the potential to create significant tension between traders and the CRO. That potential, and practical experiences of it in action, is a key concern of the current chapter.

Not all CROs accepted this, somewhat introverted, trading culture as found. Some described setting up outreach programmes to engage with traders and engender a broader understanding of business and enterprise risk, as opposed to market (that is, trading) risk. C1 set up a “risk ambassadors” programme recruiting staff from all divisions for risk-awareness training. C34 sent out a series of internal circulars “promoting risk-awareness” with the notion that

“risk management is not just a task for specialist risk analysts; everyone in the business has a responsibility for it.” (C34)

From the evidence of respondents’ experiences, those banks that had set up such “risk ambassador” programmes (C1) were the ones which best weathered the

2008 crash. C3 for example described a “culture change programme” of seminars for traders to “make the [trading] floor more sensitive”, which

“did get some results, I think. It increased the sensitivity to these problems. So you go through the exercise, you explain it to people, and the smart people will get it. Some [business units] are better than others, conveying the message with strength and taking the message seriously.” (C3)

While respondents could choose to seek support from senior management, the Board or even call in the FSA, such remedies might be expected to be regarded as a last resort. Seeking help from the regulator, in particular, was commonly regarded as a “nuclear option” (C16) with potentially career-damaging consequences. Given the structures outlined above, one might expect to find some invoking of senior internal support, as a less optimal coping strategy, rather than risking more direct detriment to their careers. This raises the related question of research expectations regarding the role of the Board, which is now considered.

6.2.4 Note concerning the expected role of the Board

Given the, somewhat skewed, weight of responsibility that the CRO bears for identifying and reporting risk, one might expect the Board to offer solid support whenever the CRO needs to resolve any risk issues arising from the trading floor. At Board level, however, once again the CRO experience of engagement with risk issues deviates from the (idealised) construct of the control system, in ways which demand closer study.

In fact, the Board’s engagement with risk reporting is found by this research to be so strongly influenced by the informal organization and private incentives that it will be given a separate chapter to itself (see chapter 7). The rest of the current chapter will maintain focus on the interactions of CROs and traders.

6.3 What happens in practice: Negotiating compliance

6.3.1 Control system ideals versus routine experience

The previous section outlined options available for a CRO to take action to secure traders' compliance with requests for information. The remainder of this section (6.3) now revisits each of the options from section 6.2.2, to reconsider and illustrate each one with CROs' narrated accounts of the responses actually received.

At the end of the chapter, CROs' responses to these responses are also considered: that is, the further options that a CRO might try to pursue in any subsequent attempts to manage non-compliant responses. Raised here, but examined in detail in the chapter 7, is the related central question of whether a CRO's appeal for senior management support may be expected to achieve a positive outcome for risk control when ordinary attempts fail.

6.3.2 Asking for information about risk: Regulatory capital manipulation, “structuring out” and other “ambushes”

As noted, a key responsibility of the CRO is to produce a headline figure for the bank's Regulatory Capital and to publish this to the regulator. Unfortunately for the CRO, following the description of systemic tensions with traders (see 6.2.3), it is evident that traders resent any back-office intervention which interrupts the flow of cash available for trading activity. Several CROs, and notably C11 who discussed this concern at length, reported that regulatory capital is widely regarded by front offices as “a wasted asset” (C11); that is, potentially tradeable cash tied up by regulatory bureaucracy. This source of conflict is a recurrent theme in interviews when discussing the subject of interactions with front office (and with Finance departments – again, see chapter 7).

Traders' resistance to engaging with CROs' requests for support in reporting regulatory capital comes in many forms. First, the front office may reject the CRO as a person who need not be taken seriously because he lacks direct experience of product development. For example C8 recalls what happened after

she arrived in a new post and attempted to justify information requests on the, fairly straightforward, grounds that the information needed to be fed into the risk models which the bank used to calculate regulatory capital:

“Whenever I moved around in the front office environment there was a lot of feedback about the Risk Office relying on econometrics too much. We were looking at the [regulatory capital adequacy] numbers, for Basle, and fingers were pointing upwards to us saying ‘they don’t quite understand our business, they’re coming up with this number but we don’t understand where it comes from’. As Risk Officer you do get used to that.”

(C8)

This sense of frustrated reasonable expectations is a recurrent theme which CROs quickly factor into their approach to the role. Many describe adapting their behaviour, at first, to engage in minor tactics to conciliate with traders, such as by appealing to a sense of common purpose within the bank. One approach, described by C7, is to suggest to the front office that “life would be simpler for everybody” if disparate risk reporting lines were combined, to reduce the number of requests for information:

“Arriving as CRO, what I tried to do was make sure that all the separate risk functions were seen as one risk function. There had been definite distinctions for example between compliance, operational risk and financial crime, even if they’d been reporting to the same person.” (C7)

Where C7 attempted to succeed by making common cause with the traders, others such as C15 viewed such interaction was a form of “game” to be played, of anticipating the traders’ next move,. C15 challenged the resistance of traders by

“not becoming part of their game but by trying to understand the game so that we can see where there’s a more rational answer than gaming [the risk controls]. I’m trying to get back into the business and understand why they’re trying to [game]. Then saying, actually there’s a simpler solution which is that we’ll get it right, let’s fix it rather than play a game.” (C15)

For C15 the tactic was to find, or otherwise create, an objective which the traders could support. By contrast, C7 argues that this approach can only work if the

front office involves the CRO in dialogue about product sales and development in the first place. For C7, as for many other respondents, there was an unwelcome moment of discovery that they had been “structured out” of product development discussions, either by not being invited at all, or by being asked so late in the development process that their opinion might be disregarded. A common concern was the likelihood of discovering a problem with a new product only

“after the events, because you haven’t been in there [product development meetings] understanding and trying to pre-empt [risk] stuff that is bubbling away where it’s very easy for those (product development) people to hide it.” (C7)

Another commonly experienced form of pre 2008 exclusion was for front offices to acknowledge that risk reporting is necessary but either to appoint directly or adopt from the back office a member of staff willing to support traders’ requirements. Many respondents recount the experience, again soon after being appointed to their role, of finding unwelcome surprises on entering the front office. C12 recalls his bank’s trading floor being literally inaccessible to any non-trader staff, having its own security-sealed suite in a basement,

“out of sight of any of our retail banking staff – and of course me, at that point” (C12)

Two sources also reported, anecdotally, the case of a bank where there were two separate tiers of lifts in the office block; one with access to the trading floor, the other with access to the back office, and crucially neither one having access to the other department’s workspace.

C27 offered several alarming personal examples of “arrival week surprises”, some of which show extreme forms of direct structural challenge to the CRO’s authority. First, the front office simply assumed authority over a back office function (such as, here, credit lines – that is, the back-office limit on how much credit any one trader may risk in the market):

“There was a ‘guru’ in the front office who no one understood but he was somehow running the credit lines in the front office – and later of course we found he had built a model that hid all the front office’s losses.” (C27)

Second, when its new team of traders took direct action to create their own management systems, the same bank discovered that back office (and senior management) could be “ambushed” by ambitious traders into accepting a risk already taken. C27 again:

“The bank had hired in a lot of new ‘top traders’ from big-name US banks, as they wanted to build an investment bank. The old school, agricultural-bank guys on the Board were pushing back a bit but the trading guys would go in and blind them with numbers and cash returns. There was an obvious gap not just in culture but in processing speed between the old, slow, steady back-office processing and the high speed the new traders wanted. With a new trading floor the traders suddenly started trading lots of swaps. The [back office] settlement team, who were used to processing just a few swaps contracts a day, started screaming at each other. Then the settlement team started trying to hold the trading team to ransom, while the trading team just pressed on with a whole lot more [trades], but these looked like losing money because they’d be fined for not settling correctly.” (C27)

Such extreme cases aside, respondents commonly cited examples of their employer bank empowering traders to take on a view of risk which should, they felt, be the CRO’s function. A similar, if more structurally embedded, surprise greeted C11, this time in the form of the prevailing culture around the purpose and significance of risk information in general:

“I found that this bank encourages junior risk managers to make soft assumptions about risks” (C11)

– that is, junior back office staff were encouraged to adjust risk control models towards commercially favourable outcomes. Meanwhile the front-office product developers in the same bank

“...mostly treat with contempt any set of risk measures. They see measures of risk as designed for ‘compliance’, meaning for the back office to play with, rather than to protect the bank’s shareholders.” (C11)

The key to getting co-operation, for some, lay in building some form of strategic alliance with a “front office-type person”, says C7, who for a while after arrival had been finding that there were

“constantly cases where we needed to extract information from some particular group of people that they weren’t willing to share. Eventually I [co-opted] a senior product manager and then I was beginning to get traction.” (C7)

Traders told some respondents that the risks taken by one trading team need not be significant to the bank as a whole as they could be “diluted within the bank’s aggregate figure for regulatory capital” (C24). Clearly, though, if every trading team were to take the attitude that any local problems may be concealed within a larger figure for headline risk, this would build up into a real danger that the headline risk (regulatory capital) figure may end up hiding a significantly larger problem of unacknowledged risk-taking. This is one reason why newly appointed CROs described spending much of their time seeking to clarify, for their own peace of mind, where the components of the regulatory capital figure come from. Meanwhile longer-serving, and thus perhaps more jaded, CROs recognised that one way to make their own lives significantly easier was to succumb to front-office demands to manipulate the regulatory capital figure to keep it artificially low.

As noted in 6.2.3, purely in terms of management responsibility traders do not need to concern themselves with regulatory capital reporting. In fact, an even bigger concern for the bank as a business is its economic capital cost (or “business risk”) – that is, what it costs to fund the capital required to support the day-to-day operation of the whole bank. Business risk is a feature of the internal management accounts, and is reported in moderated form in the year-end report of the bank as a public company, but this information does not concern traders. The only type of capital that concerns them, because they see any increase in it as effectively reducing cash available for trading, is the “technically prescribed, constructed and manipulable” (C24) figure for regulatory capital. CROs themselves broadly acknowledged that regulatory capital is a construct, artificial and misleading:

“beyond irrelevant – no measure of the real state of the business” (C29).

Nevertheless, front offices consistently demanded that CROs commit to lowering their bank's regulatory capital, and would provide information in forms that supported this aim. Some went even further, such as by "going freelance" on risk, as C27 recalls, with an account of finding that one front-office team had appointed its own attached risk manager, who on closer examination was found to be

"responsible for measuring risk for more than 50% of the bank's wholesale assets. And this guy was being rewarded – with bonuses – according to how much he managed to reduce regulatory capital." (C27)

The tension over regulatory capital highlights a contradiction at the heart of the CRO role: For many banks, the CRO is there to help make a business case. Yet the lowering of regulatory capital, often by means of CRO-endorsed manipulation, increases risk to the public: Just as Northern Rock, the Scottish banks and others found in 2007-8, if a bank's trades go bad and it is undercapitalised, only a takeover or a bail-out from the public purse can rescue it. CROs here admit to bearing some responsibility by succumbing to front office pressure to reveal less risk by maintaining accounting procedures which separated sales from headline figures.

The reported figure for risk capital may be "constructed" (C24) by the CRO to allow a bank to keep separate the true results of sales activity (net profit, or margin) from the headline sales figure. This reporting sleight-of-hand encourages front office teams to continue to claim superior status within the bank, as revenue generators meriting respect and support from everyone else. Although CROs recognise the problem, few are willing to mount a personal challenge to the embedded culture of sales reporting. A common perception was that traders appreciated a CRO's efforts to reduce regulatory capital because this freed up more funds for traders to place in the market:.

"As CRO I was told that my job was to reduce regulatory capital, pure and simple. Anything else was a side-show." (C4)

If requests for day-to-day financial data could be routinely blocked, it might be expected that the CRO could seek to achieve greater success by applying

pressure elsewhere, such as by managing risk through the setting and monitoring aggregate targets for acceptable risk-taking. The following subsection reviews respondents' experiences of taking this approach.

6.3.3 Setting risk limits: “after the event” and ineffectual?

When attempting to set a limit on levels of acceptable risk that traders could take, the CRO might perhaps have been expected to take comfort in the knowledge that this was executing a direct instruction both from senior management and the regulator: to prevent the bank from slipping into “overtrading”; that is, to prevent it taking bigger market risks than it can fund from its own capital resources.

However, as seen in earlier sections, because regulatory risk reports also rely upon the cooperation of traders in the verification of figures, some difficulties were encountered in practice. First among these was the matter of timely reporting. For the front office, compiling figures on trading volumes and risk profiles was regarded as a secondary activity to the primary matter of making sales. The regulatory analysis of risk was also seen as less important than the practical testing of risks by markets (that is, by making sales and observing the result). Regulatory risk reports were criticised as being retrospective, rather than having any significance “in the moment” where the financial markets judge values. C6 explained this with an analogy:

“Front office take a much more, sort of, ‘speed camera’ approach to risk. It’s kind of ‘don’t get caught, then it’s fine’. Except that it’s your job to take photos! Whereas [back office] are geared up to taking the ‘health and safety’ view, why they don’t want to do things, and agree the rules defining where they want to be.”
(C6)

As seen with regulatory capital reporting, the construction of regulatory risk reporting for individual products was, say respondents, regarded by sales staff as a matter for negotiation between product developers and CROs. Sometimes even a negotiated agreement was seen as an afterthought, the main thrust being to get a product into the market. Respondents pointed to this as one of several tactics used by front office to restrict the impact of the CRO on trading activity.

Product developers, said C26, could get the product risk profile they wanted by “cherry-picking” information to support their case. Product teams were found to be meeting targets by

“just pre-defining a population that was achievable. You’d superimpose criteria that excluded things that might be inconvenient... Like, ‘I’m going to include this counterparty because they’re clearly my friend’. It’s kind of about finding the information you need, rather than just it naturally being there.”
(C26)

C20 suggested that this behaviour prevailed because there was little systemic encouragement to consider loss-making consequences in a marketplace that focuses on short-term turnover – that is, simple headline sales. The “virtuality” of financial products was, he said a significant factor, removing traders from any real sense of making profits and losses:

“In the tangible world of goods, if you don’t make something that works, you’re found out very quickly. But in our intangible world of promises you can lose ‘risk failures’, or whatever you want to call them, for a very long time before they come home to roost.”
(C20)

Many front offices appeared to view public risk controls as something to be added on after a product had been specified. There was seen to be a bias in action against engaging the CRO in dialogue about risk whilst the product is under development. Respondents referred to this problem in various ways. C27, C15 and C34’s points illustrate the same, widely perceived, problem of their non-involvement in product design:

“Risk systems have not been designed to anticipate risk but as an ‘after the event’ task to satisfy the rules and ensure there was an audit trail to show the bank had acted within the rules.” (C27)

“Even when you’ve got a separate back-office risk function that does model validation or model running, they’re still aligned too much with the business... [there’s] inadequate challenge, not enough questioning of what goes on in those models, the huge number of assumptions underneath.” (C15)

“Risk office were just [expected to be] reactive to incidents and struggled to follow up [design] issues.” (C34)

Before moving to consider what happens when a CRO invokes internal (Board) or external (FSA) support when traders do not comply with requests for information, it is relevant to note that the personality of the CRO is also seen as having a potentially significant impact on interactions with traders. A CRO may approach a front-office negotiation in various ways, which respondents broadly summarise into three approaches: First, using robust demand and challenge; second, using gentle pressure for incremental change; third, trying to accommodate with existing practice (which approach may, over time, turn into simple acquiescence).

Out of all CRO respondents, two were notable as CROs who had previously been traders, and were accorded a higher level of respect (and reportedly compliance) than others, although the respondent base is too small a number for this to be statistically significant. For the rest, given an apparent tactical choice between robust challenge, incremental change, and acquiescence, many reported the experience as being pushed by the prevailing culture towards acquiescence. Some, such as C11 here, attempted to rationalise this as bowing gracefully to an unbeatable commercial pressure:

“It can help to be quite focused on commercial outcomes if you’re in a risk analysis area. Why? Because you’re doing what the business wants.” (C11)

Some selected their response according to how willingly they expected to find engagement with certain different personality types encountered in the front office. C5 acknowledged that

“...you always have to worry if the product leader is a big, bullying kind of character, as then it becomes quite difficult to stand up to.” (C5)

Sometimes, differences in interpretation of compliance requests were ascribed to simple differences in outlook between front and back offices, as in C27’s experience:

“The (back office) head of credit risk thought I was there to bring in controls and remove credit review from the front office; the traders thought I was there to confirm what they were doing and sign it off.” (C27)

The commercial imperative came not just from the trading floor but from an attitude of management higher up the bank hierarchy. Selling was seen in the context of reporting corporate success, as C7 discovered as a legacy from his predecessor, calling into question the role of senior management in endorsing consequence-free sales activity. Sales staff told C7 that

“...the key objective here is to get as many of these new mortgages as we can on the books, to drive profitability. We realise that there are some flaws but that’s not the priority for us.” (C7)

C7 concluded that his predecessor had

“somehow got carried along in this tidal wave of enthusiasm for profit, he sort of backed down from the issue to the point where some things started to go badly wrong.” (C7)

The role of senior management in relation to this culture will be examined in Chapter 7. Meanwhile, the next subsection considers the CRO’s options for engendering a more supportive response to internal compliance requests.

6.3.4 Internal attempts to enforce compliance: three possible strategies emerge

For the CRO attempting to achieve change, whether by major overhaul or through a series of smaller steps towards improvement, the challenge was seen as being how to react to an initial non-compliant response: what should be the next move?

Rather than immediately calling for senior management support, many respondents recognised that a second personal attempt to obtain compliance might give the traders a sign that the CRO expected not to be contradicted; that a more robust personality was at work. If the aim was to earn traders’ respect, this

strategy of returning to the challenge in practice achieved mixed results. Some respondents then sought to deflect criticism by making allowances (that is, excuses) for front office staff hostility: traders simply “get too busy” (C27); although the bank had a “great governance framework... [respect for it] on the front office side of the house does fall down rather” (C10); that compliance demands do not accommodate “the harsh realities of the commercial world” (C18). A more reflective, and less evasive, explanation of why front offices succeed in rebuffing the CRO is that compliance requests are simply reconceived and then discounted “over time [as] just a process, just a piece of paper that doesn’t mean anything” (C27).

The challenge facing the CRO was thus to get these “pieces of paper” to have greater meaning. C17 suggested that a CRO should consider the challenge in terms of how to communicate to traders one’s attitude towards being appointed CRO in the first place. Whether traders perceive the CRO as having authority is

“a function of how you approach the (CRO) job. If you’re there just to count the beans, perhaps you’re not going to do yourself any favours. If you’re there to add value in terms of new product design, maybe you’re accorded greater respect.” (C17)

A willingness to acknowledge frankly the bank’s commercial agenda, then, was seen by banking colleagues as a strength, whilst an adherence to regulatory compliance dogma tended not to win any allies. For most CROs, making progress was a matter of accepting and working around the reality that they were nominally in a senior role yet in practice had little authority beyond what they could create for themselves through the use of charm, robust (ideally ex-trader) credentials or otherwise mere force of personality. C20 defined the problem as a matter of how to make sense of, and move on from, one’s personal experiences. Being given “nominal authority to intervene within the organization” did not result in an “experience that that authority is real” (C20).

The problem of achieving real, exercisable authority was defined by respondents as processing how the encounters with the front office escalate, either as to co-operation or confrontation. The following experiences illustrate some experiences of points on a notional “scale of compliance” ranging between full support and outright defiance; this notional scale is expanded upon in Chapter 8.

At the optimistic end of the scale, C20 was a challenger of the *status quo* and who experienced a violent reaction when he carried this challenge into the Boardroom (see Chapter 7). C20's approach to his engagement was clear, robust, and showed a realistic appreciation of the challenges faced by a CRO in confronting the incentive structures that determine traders' behaviour. Traders will "do things" (such as comply with a request for risk information) if

"they think there is a negative if they don't do them and a positive if they do do them. So: we paid bankers to grow assets and what have they done? They've grown assets. Amen."

(C20)

C6 described the challenge to the CRO as being to maintain the ability to give an objective opinion, and not to "go native in the front office". Both C20 and C6 did not see this formidable hurdle as an excuse to capitulate to front office interests. The front office was though found to be quite ready to use its technical knowledge and practical experience to undermine the authority of a CRO who tried to engage with it. C15 found that product developers' disengagement from responsibility for risk reporting could be

"quite assertive, reinforced by the technical expertise of the people that developed the [product's risk] model because nobody else really understands it. They'll say, well this [risk office] guy is asking these questions because he doesn't really understand it."

(C15)

Meanwhile, at the opposite end of the scale, capitulation could appear as an attractive option for any CRO less keen than C20 to seek a personal profile as a campaigner for corporate probity (and more keen, perhaps, to regard acceptance of their salary as fair compensation for offering "flexible ethics" or "business support" services as required by the employer). For the CRO who capitulated to commercial interests, the hope was merely that nothing embarrassing will happen to the bank during their tenure. In any event, following the market shocks of 2007-8, according to several respondents, as many as one in three CROs found themselves seeking new employment. Whether these were victims or perpetrators of manipulative risk reports may never be known.

In the present research no CRO has described taking up their appointment with an initial strategy of capitulation. Most, however, do describe a process of

gradually or suddenly discovering an alternative reality of (non)compliance, starting soon after their arrival in role, after which they found themselves forced to reconsider their options for adapting to this reality. If strongly signalled by front office – or, as will be seen in chapter 7, others in the organization – that they could not beat the system, they might elect to survive by accepting this and adapting their own behavioural responses to this commercial reality. C4 recalled a sensation of “sliding down an ethical slope” after finding a systemic risk reporting problem which was

“clear to me [but] no-one felt much like challenging it, with bonuses coming. You’re basically being bought. So you say to yourself: ‘There may have been something going on there but I don’t think that was a real driving thing, I’m just part of this process, there’ll always be someone else who must know what he’s talking about if I don’t’.” (C4)

In this case, the CRO invoked a form of denial also observed in some Boardrooms during the latest banking crisis, and a notable factor in earlier crises such as the Barings crash of 1995: The belief – or more correctly, hope – was that someone else in the room had a better technical understanding of the risk which was engulfing them. In a CRO, as in a Board of Directors, this is in practice an abdication of responsibility. The last word in this subsection should go to respondent C5 who agreed, with several other respondents, to a follow-up interview late in 2008, as and after the market crashed, accepting that this was “exercising 20-20 hindsight”:

“With assertiveness, as CRO you’re rather caught between a rock and a hard place. Several CROs [after the crash] say if only they could have seen what was ahead in the market place they would have been a lot more assertive with senior people in their businesses. I’d say yes, CROs have failed in that we just weren’t as assertive as we should have been.” (C5)

6.3.5 Invoking senior management support

Failure to secure a positive response to information requests from traders ultimately might require the CRO to appeal to higher authorities for support. This would not ordinarily be seen to be a very significant step; the CRO might

reasonably expect senior management support for some routine demands. Some positive experiences are noted here to illustrate that this course of action need not be exceptional, either as a strategy or in the results which it delivers. However, as there was also a significant potential for other (unexpected and unwanted) results, these other outcomes are reviewed separately in Chapter 7.

Any invoking by the CRO of other authority had the potential to be interpreted by traders as a loss of authority by the CRO, so requests for support were carefully considered and executed. Three positive experiences here make the point that this option could be successfully pursued, although a fourth respondent, C15, also points to a “sting in the tail” which is further explored in the next chapter.

C22, first, advocated taking “rational argument” as far as possible with traders to get a response, but if that failed, not to hesitate to

“use the Board level to say ‘look, when the head of wholesale banking says you’ve got to do it, you’ve got to do it’.” (C22)

As a former trader, with the added authority that that experience conferred, C25 might have been expected to have less reason than other CROs to call on senior support. Yet he was a strong advocate for using this tactic, which he (with some others) referred to as ‘air cover’, as a way of forcing traders to acknowledge their reporting responsibilities. His chosen form of ‘air cover’ was to arrange a carefully timed and targeted call from the bank’s Chief Executive to the head of the trading desk which had caused the problem, to deliver the message that

“risk governance matters [to this bank] and there’s a major goal to keep the business within capital constraints. I know what reaction I’ll get. I can call up an ‘air strike’ and it’s devastating.” (C25)

C8 approached another Board member, the Managing Director of the bank’s trading division, to get authority to bring in external auditors for an independent report on risk-taking, after visiting the front office to find that

“...people refused to co-operate. We were trying to get the traders to look at a daily compliance indicator but it was turning into some big, you know ‘exercise’ for them, ‘too much information, log off this, sign off that’. So then they all pushed back and the heads of desks said ‘we’re going to walk out if you force us to do this’. I then had to take it up a level, we had to get the external auditors in, which caused even more of a riot. The auditors had to work with us [the Risk team] to agree what we should have in place. But to get there I’d had to go above all the heads of [trading] desks and get the head of business to stamp on them and say ‘you’re doing it or you’re out’. So they just shut up and got on with it afterwards.” (C8)

C3 adopted another alternative strategic view, that a good CRO should remember not to have the role defined for them by others as “pure compliance”, since this limits the possible points of contact with the Board. A serious infraction might not be simply a matter for a head of business but could enable the CRO to make a direct approach to the bank’s senior in-house lawyer (the Head of the Legal Department, also known as Corporate General Counsel). As C3 summarised this strategy:

“[One] shouldn’t make the mistake of defining all problems as regulatory. Fraud is just fraud.” (C3)

Respondents including C15 noted that invoking any form of higher support, whether from the Board or externally, was a “high stakes game” or “nuclear option”. He meant by this that if the resulting intervention goes wrong – or even is less than fully successful in securing compliance – this can turn out to have been a tactic which has a bad impact on the CRO’s career. As C15 said, pre-planning was essential, as was personal knowledge of the Chief Executive, to pre-assess the likely response to a call:

“If you do need to step around those product people, it’s crucial that you have access to the CEO, and if *he* doesn’t want to listen, that you have absolute clear access to into the Risk and Audit committee, or whatever the Board calls it. Though the danger is that’s seen as the ‘nuclear option’ – it does destroy relationships that you have within the business, so how often can you use that?” (C15)

6.3.6 Invoking external support

As seen in Chapter 5, a further factor dissuading the CRO from calling the FSA for support is anxiety that the regulator itself may not respond positively – or even competently or predictably – to being called in. As C4 saw it, with hindsight after the market crash:

“As a CRO you’re never sure of what sort of support you’re going to get from the FSA. Theoretically you have all sorts of whistle-blowing powers but you may just be hanging yourself [by making a report], by going right out on a limb, all the time thinking ‘What’s the FSA going to do? I’ll never get another job in the City again, they’re going to hang me out, oh and by the way the chances of them actually doing anything to solve the problem are tending to zero anyway’.” (C4)

The same respondent suggested that the front office’s reaction to being threatened with FSA intervention had also changed since the crash, in two ways: Traders were more aware that the CRO may threaten to call the FSA; but traders were also more fatalistic about what might happen next. As C4 explained, whilst the threat of FSA action could get everyone’s attention, among some of the more cynical traders the response might be, in effect, a petulant ‘so what?’:

“One of the things the crisis changed is for the CRO now to be able to say, if you don’t do this, now I’m going to the police, to the FSA, so now front-office people are sitting up and going, whoa fine okay, let’s not do that. But then again many [traders] got into such a bad state [in 2008], so they’re just saying, ‘Well what are you going to tell them? What’s the worst that could happen? It can’t get any worse’.” (C4)

Both of these situations suggest that such a course of action could easily undermine the CRO’s already fragile authority within the bank and would be not just counterproductive to short-term compliance but also probably career-threatening.

C15 was more optimistic, suggesting that early engagement with the regulator could be a way to anticipate and defuse problems, although he was also a realist in recognising that this approach has consequences for a CRO’s personal standing with the front office:

“Early disclosure makes for a better relationship with the FSA overall, but it makes life quite uncomfortable; you take quite a lot of heat internally for adopting that approach.” (C15)

As with calls to the Board, the secret of evoking an effective FSA intervention was regarded as how good a relationship the CRO had taken the trouble to establish with the regulator beforehand. This was, in turn, partly a factor of how far the bank collectively encouraged a good working relationship with the FSA in the first place, as C5 said:

“How much traction the CRO function has within the firm says a lot about the relationship between regulator and regulated. [Whilst] a proper, serious, big firm will have proper engagement with risk at business level... a small-to-middle, or ‘not serious’ firm may well just dump anything that comes out of the FSA on some compliance officer, or they’ll use [Risk office] as a filter, or just a dumping ground.” (C5)

As C18 pointed out, one quick way to appraise “how seriously a bank takes its compliance obligations” is to check how much budget the bank allocates to the CRO’s team as a proportion of its business overheads. C18 recalled attending a budgeting meeting to discuss whether to fund a fraud-prevention system, where the finance department was “saying ‘we are prepared to give just this much resource to your activity’”, even if the CRO’s proposal had the potential to “screen out all sorts of bad guys” (C18). The clear implication is that the Finance team might allow the CRO to do only as much as was “good for business” (C18) – meaning, not disruptive to existing trading activity.

6.4 Is internal co-operation effective?

The preceding sections provide clear evidence of various forms of breakdown in co-operation and compliance between the front office and the CRO. Faced with traders’ non-compliance, as has been seen, the CRO might resort to repeated questioning or invoking various forms of support to deal with specific incidents. This raises a further question of how the CRO might manage in the longer term; that is, in making sense of a role which might entail a daily struggle to resolve

continuing conflict between the duty to public reporting and the private motives of profit and career survival. If trader non-cooperation was a common occurrence, how could the CRO respond to this challenge in a sustainable manner, to maintain authority and credibility?

As front-line agents of public responsibility within an often hostile corporate environment, respondents said that they employed a range of coping strategies designed to maintain at least a little functional efficacy in role and to offer some comfort to personal morale.

“Some of the most successful people in a commercial environment will operate on deniability lines.” (C18)

The term “coping mechanisms” (Lipsky 1980) may describe a set of general responses used to overcome lack of resources and controls, unclear aims, and organizational tensions. Respondent REG1 offered a view of the process in action, recalling a “cynical” CRO colleague’s approach to assessing which factors informed the organization’s decisions on ethical reporting:

“One CRO who had a dilemma had to report a problem to the CFO but he saw that he only had one shot at getting it right, if he got it wrong he’d immediately be fired because the CFO was his messenger to the Board. But do you know, he was less concerned about being fired so much as getting the message across. Although theoretically as the CRO he had the ability to bang the desk and go in and talk to the FSA, and go to the Board immediately and say there’s a problem, he knew that actually he would be undermined and not supported.” (REG1)

Faced with such obstacles – as Lipsky had predicted – the risk officer might turn to one of three types of coping practice: creation of routines and stereotypes (a time-saving form of practical heuristics); redefinition of the job or task, to make resources seem better able to address the objectives; and selective description of clients, with the emphasis on any characteristics which the officers had succeeded in influencing.

Reflecting on these, other organization-level coping responses included invoking of routine or stereotype reporting (Power's [2006] "audit rituals") to suppress concerns. A supportive element, across entire businesses, was the prevailing "blind faith" (C12) in pre-selected econometric risk models. C7 described sales managers' use of a risk matrix as

"a 'comfort blanket' for the Board, sort of them just looking at nice reports and saying, OK, so by default then there can't be a problem in that area so let's move on to the next agenda item."
(C7)

Respondents offered many examples of organizational coping in the context of Board decision-making and corporate governance. One normative response was local redefinition (reframing – sometimes with the regulator's collusion) of "what the regulator really wanted" (as predicted by Yapp and Fairman [2005] and Kaplan [2008]). C18 regarded the regulator as knowingly engaging in this activity as well:

"I would like to believe there are pure motives for regulation, like that you want fairness in the market, you think people ought to come with clean hands and behave appropriately. But I realise that may be considered a somewhat naïve view. I know on the regulator's side that they might sometimes have developed their own set of internal rules to stave off government interference in how they did their business. There's political input in that process."
(C18)

C34 reported it as more an instrumental activity by product developers:

"Controls were developed with a view to satisfying the regulator's evidence requirements rather than addressing actual elements of risk."
(C34)

The reframing of a regulator's demands is part of the collective act of cognition produced in the informal (as opposed to formal) organization. The informal organization pools its constituents' many private interpretations and cognitions of risk (reminiscent of Beck's [1999] "risk society"). As the informal organization redefined the reporting task, for its own benefit, though often not

for the CRO's, ethical concerns could be excluded. Some CROs, such as C21, were frankly pragmatic about their part in this:

“Absolutely I’m here to reconcile compliance needs with marketing needs.”
(C21)

Respondents offered many examples of misalignment between the motives of policymakers and bankers. SM1 suggested that the weighty compliance reports that he was statutorily required to produce were evidence that regulatory policy was out of touch with reality:

“There’s a fundamental inability [by the regulator] to recognise that a 700 page compliance report is useless, in practice.” (SM1)

Having reviewed traders’ interactions with CROs, the following section will reflect on findings, to highlight the influence of organizational culture in shaping the CRO’s behaviour.

6.5 Reflection on findings: response strategies available to CROs

Where Chapter 5 established that certain “games” of response to the regulator are widely noted, Chapter 6 has considered whether traders are a significant source of pressure for the organization to engage in creative coping response to demands for risk reporting. It does not appear to matter to traders whether the compliance demands originate with the CRO or externally. This calls into question a tenet of Ayres and Braithwaite’s enforced self-regulation model, that there is a distinction between “insiders” and “outsiders” in the control process. The unsound assumption is that, as an apparent “insider”, the CRO will be given good access to trading information. As has been seen, in practice the line between “inside” and “outside” should more realistically be drawn between the front office and everyone else (including, that is, back office and regulator). Whether a bank’s Directors are inside or outside the line is a significant factor, to be addressed in the following chapter.

Respondents' stories point to the existence of a strong though informal organizational culture within which the CRO is required to operate. The evidence indicates that CROs are induced by this culture to modify their behaviour, and hence performance of their job, to subsume their personal preferences to the dominant organizational approach to business ("the way we do things around here"). Facing routine challenges to their authority, CROs may opt to resist, debate with, or acquiesce to this prevailing culture.

The structural implications of the tensions within the CRO role emerge as a key finding. In particular, failure of the expected function of the CRO as an "honest intermediary" between the firm and the regulator encourages a questioning of structural weaknesses, which result from designed-in conflicts of interest, such as between the CRO's public-office function and its private-employer funding. The regulator's expectations that the CRO would exert formal power in the organization are confounded by the CRO's lack of any real traction over colleagues' behaviour.

The issue of perceived and actual power also invites further empirical exploration of the regulatees' flexible notions of compliance, or creative compliance, including coping and even gaming responses.

Broadly, three responses are available to the CRO when faced with intransigent (and more powerful) front-office interests. The first is to cling firmly to one's public-service principles and challenge the situation as found. The second is to press for change but without confrontation, which in practice means seeking incremental improvements, negotiating one step at a time. The third response is to capitulate; that is, to abandon any attempt to change the compliance culture, hoping that no major infractions occur on one's own watch, and perhaps consoled by the thought that one's term of office is limited and will be over soon enough.

Through these interviews, it now appears that many bankers conceive compliance not as a binary choice (that is, to comply, or not to comply) but more

as a linear scale ranging from full compliance to full defiance (or simply fraud). A base of 35 respondents cannot offer meaningful calibration of such a “scale of compliance intent”. However, future research, with greater resources, may later come to develop the scale to a point where the attitudes of regulatees may be indexed precisely. A prototype of the scale is offered in Chapter 8, to assist focus on the issue of whether bankers respond adversely to a regulator increasing demands for reporting – as other regulated groups have been found to do. As pressure for compliance increases, are bank staff more likely to respond by coping? Will coping be found to include subverting various reporting systems?

Because the most profound impact is on the senior individual expected to “cope” on behalf of the organization, the final chapter of empirical review will consider CROs’ private attempts to deal with the consequences, in the form of personal coping and sense-making.

CHAPTER 7: CROs' RELATIONSHIPS WITH BOARDS OF DIRECTORS

“So my Finance Director said to me – as I was then Head of Risk Management – ‘What’s all this talk about needing a CRO? Who is our CRO?’ Then he pointed to me and I pointed to him!”
(C1)

7.1 Introduction

Chapters 5 and 6 investigated CROs' interactions with the FSA and with traders. As has been seen, the regulator may make misplaced assumptions about the extent to which a bank may be expected, in practice, to comply with demands for risk reporting. Further, within the bank, traders' unresponsiveness is a source of tension for CROs attempting to report on risk, although this factor alone appears insufficient to explain why CROs are unable to fulfil their reporting responsibilities.

Were CROs not receiving senior colleagues' support when attempting to exercise authority over traders, even though they might reasonably expect the Board to provide this? Whether the Board gave the CRO support, or withheld it, would change the complexion of the CRO role very significantly. Withheld Board support might be expected to isolate the Risk function within the organization. Chapter 7 will therefore investigate whether perceived Board support was a significant factor in the CROs' experience of their role.

In now considering CRO interactions with the Board, the research in this chapter also explores further respondents' private strategies for surviving in a senior management role in the event that Board support was lacking.

7.2 How CRO-Board interaction was supposed to work

7.2.1 The CRO responsibility as formally designated

Most CROs had a job title which included the word “Director” but, of those interviewed, only two had seats on the Executive Board of their employer bank. Although their precise position in the Board hierarchy thus varied, every CRO had some access to the Board as a function of the role itself. The role as understood from FSA guidance – though not a precise specification – included being able to review, comment on, and if necessary challenge decisions on risk at a strategic level (see Chapter 2).

Moderating this, respondents mentioned a range of common expectations, in practice, on the part of their employer banks. The broad task of overseeing risk at corporate level might be subdivided according to the particular bank’s trading activities but would usually include the core functions of: *collating* – that is, integrating risk reports from across various business lines; regular headline reporting on key *trading risks* (credit and market risk) to the Board, and answering their questions on these; *compliance* with public risk reporting requirements, and acting as the lead point of *contact* for the regulator and auditors; originating and publishing a *risk policy* setting out the corporate approach to managing risk, and monitoring how this is working.

7.2.2 Expected interaction with the Board

One might reasonably expect the Executive Board to adopt a more sophisticated, enterprise-wide view of risk than the traders, and so to be more positive in interactions with the CRO. A CRO seeking to achieve greater traction over unresponsive traders might therefore reasonably expect to look to the Board for support. Indeed, the CRO might be expected to look to the Board for help in devising a strategic solution to the structural tension between public-facing duty to report on risk and the employer-funded impulse to suppress inconvenient trading data.

Practical access was a related issue, since respondents varied in their levels of direct access to the Board. Apart from two Executive Board member CROs, most other respondents attended some, but not all, Board meetings. A commonly described arrangement was for the CRO to communicate with the Board via the Finance Director (CFO) and to be called to attend specified Board meetings in order to propose a strategic approach to some risk-related concern, such as the impact of new regulatory controls, or the risk attaching to a newly developed product or market. In this regard, C7 saw the CRO as adding value to the Board debate by reminding colleagues to look beyond whichever risk metrics they have been applying to current products; the Board's function being to look past the models and deploy

“...just sound business sense. You know, taking a step back and looking at your real risks in the business, saying do we feel that the risks we're running are sensible to take in the current economic environment?”
(C7)

A normal function for the CRO was thus seen as to answer the Board's requirement to present a good, credible impression of corporate risk control for the benefit of interested parties. These parties are often described as 'stakeholders', and for the Board's purposes are primarily taken to mean shareholders. Respondents also noted that their Boards acknowledged – albeit as secondary incentives – the interest of customers and employees; social and environmental impacts; and the regulator.

7.2.3 The Board's expectations of the CRO

Respondents recognised that their formal mandate of public reporting was moderated by their employer Board's commercial outlook. Where traders saw risk in terms of the market risk attaching to the sales they make, the Board was seen by respondents as primarily concerned with protecting business value. In practice, Boards were reported to interpret this duty as protecting the bank's share price, if publicly quoted, as well as always preserving working capital and the cost of funding this. C15 suggested that the Board had a plainly pragmatic understanding of a CRO's place at the table, which was to maintain a level of

risk-awareness necessary to support the bank's good name, or in the language of risk governance, to keep ahead of "reputation risk":

"In most Risk Directors' objectives implicitly or explicitly there is some kind of 'no surprises' policy, meaning make sure [the Board] know anything that's likely to hit the newspapers. ...The biggest element of [Board] discussions is reputation risk, how likely is it for the FSA or somebody to take action, is it on their radar, something they've been talking about in speeches, publishing documents with this scenario?" (C15)

This Board was seen as mandating the CRO to maintain, perhaps at all costs, public reporting that all was well with the bank's formal addressing of regulated risk. As C15 explained, there was a clear implication here that it could be tempting to "present well" on risk regardless of any trading problems; a good Board might though recognise this and consciously challenge this tendency. C15 recalled admiring his newly-appointed CEO as a strong leader in this respect, "very good at articulating strategy, doing things in line with it"; a man who rejected managers who tried to "do the things you'd rather be doing than what you're told to do!" (C15).

C5 reported a variant of this, in the form of a Board which sought to engage constructively in a wider debate about acceptable risk. As his Board saw it:

"we *should* ask what do we mean by, for example, regulatory risk [which] is about not being treated in the way that you thought you would be, or regulation changing in a way that you could not reasonably expect. Not just something that you don't happen to like, more the kind of level where suddenly, you know, bang, something hits you out of the left field on what we'd always thought was a reasonable way of behaving, and government suddenly costing you billions of pounds for that." (C5)

This research asked CROs how, as individuals, they interpreted their role in managing risk, including private considerations of weighing up risks to the bank against the risk to one's job tenure. This line of investigation considered whether CROs might be knowingly engaging in a form of double-standard in risk reporting, reminiscent of Cohen and Laing's (1971) "game of no game". The issue is central to understanding how CROs interpret their responsibilities as

senior managers, and to assessing whether the role has any ability to exert influence (C18's "real power") within the organization. It is worth noting at the outset that *every* respondent accepts that there is a difference between the concept and the execution of risk reports; as C2 sums this up:

"There's an expectation that you'll assert that you are fully compliant with all the laws and regulations, which of course is completely unrealistic."
(C2)

Recognising that the "unrealistic" nature of risk reporting was widely perceived, this chapter now moves to consider what actually happened to CROs who sought Board support.

7.3 A range of Board responses to CRO requests for support

7.3.1 Listening to an alternative view, and acting on it

In line with the job function as described, most respondents recalled an optimistic start to their CRO appointment. At the outset they looked forward positively to their first Board encounter, seeing it as an opportunity to engage in constructive criticism and suggest initiatives for strategic change to improve risk reporting. Where the Board was found to be supportive, some CROs described having their alternative view listened to and acted upon. C25 offered a useful contrast between his experiences of engaged and disengaged Boards:

"The difference between the bank where I am now and where I used to be is that here, risk governance matters. At the other place it wasn't seen as mattering."
(C25)

C19 had a distinctive experience, enjoying enhanced status because his credentials as a former CFO earned the respect of his new CEO:

"Because I'd come into the role through being a CFO, I had a very supportive Chief Executive; I think that [CEO support] is crucial for any CRO. If you have that, you're several steps ahead."
(C19)

C7 pointed out that, as long as the CRO approaches the task with diplomacy, the Board may welcome new approaches to risk if these offer greater clarity of understanding. In C7's experience, this meant using the new job as a platform to challenge a Board that he found to have been too dependent on econometric reports as a "comfort blanket":

"Board members [used to] just look at nice reports and saying, OK, so by default then there can't be a problem in that area so let's move on to the next agenda item. Now I can help them look beyond fancy-looking charts and be willing to rock the boat. It's about shouting loud enough to be sufficiently heard in the organization." (C7)

Several respondents reported encouraging experiences of interaction with their Boards. C15 found it helpful, before going into it, to conceive the Boardroom as a "benign debating chamber", removed from the pressures of the trading floor, which is

"good because you have someone other than 'front office' people in the room. You can force discussions down to a fairly simplistic level, ask some awkward questions." (C15)

As one of the earliest CROs appointed in a UK bank, and veteran of an earlier risk governance structure which used a credit (sub)committee of his Board, C5 was able to appeal to his Board to challenge collectively any optimistic proposals from product developers:

"If somebody did come up with a whizzo new product or whatever, we were very collegiate about the whole thing, very much using the credit committee, which anyway consisted of pretty well the whole executive committee and me as CRO chairing it. A collegiate approach (to vetting new products) is massively more effective." (C5)

One reportedly successful strategy for a new CRO engaging the Board was to present oneself as a source of education about risk. With risk concepts continuously evolving in the marketplace, the CRO could be well placed to

present themselves as interpreter of new technical language and concepts, rendering them into material which could inform a strategic commercial view. C15 did this, using the “benign debating chamber” to hold an

“important ... discussion at senior level, above the level of the people who are doing their own thing.” (C15)

He added that the Board trusted him despite admitting that they did not at first understand the problem, and regarded himself as “lucky” to have been handed “a fairly blank piece of paper”:

“When I came in, ‘holistic’ risk management was hopeless. Good individual risk silos, with thinking in their own areas, but [I had to] bring it all together and put it into a common language that you could then have a senior management debate with.” (C15)

Other CROs reported finding the Board supportive for unexpected reasons. C18 described a “strategy of super-compliance”, or “asserting a claim to virtue”. This produced a large quantity of positive reporting on risk, although not for the best of reasons; it was more a matter of a boardroom “game of quality-versus-quantity” (C18).

These positive encounters are, however, less common than reports of more energetic debate and even open conflict. At times, many respondents’ Boards were reported to be considerably less receptive to criticism of any kind, and to express this resistance in a variety of ways. The following sections review experiences of encountering less than full support from the Board.

7.3.2 Board-level resistance to CRO initiatives

The Board could resist or reject interaction with the CRO in various ways. The least challenging of these for the CRO was simply to be ignored or sidelined. This could happen either in person, or systemically because the Board could regard the CRO function as subordinate to more important concerns. For example, C24 was surprised to find that his CEO regarded risk reports as unworthy of attention:

“It’s insane really but our CEO was an actuary who didn’t like to look too hard at the risk data I produced. “ (C24)

Speaking in late 2007, C7 summed up the position of his own and many other’s Boards at that point, that the CRO represented an unwelcome regulatory “face at the table”. His Board’s reaction was that regulation in general, and compliance efforts in particular were

“just a bit of a nuisance, [it was] ‘let’s get them off our backs and get back to earning big commissions on what it is we actually do’.” (C7)

A similar experience of the Board actively discouraging the CRO from any dissent soon after his appointment to the role was reported by C20. This CRO attended his first Executive Committee meeting only to be taken out into the corridor and reprimanded by another Board member following the apparently unacceptable act of

“asking whether or not I should raise challenges of which the executives were not comfortable” (C20)

C20 interpreted this as a clear signal that the Board did not welcome an intervention from its new CRO, even though his enquiry related to a harmless point of order. To ask merely about the possibility of questioning an uncertain risk issue was hardly a direct confrontation, but this was vigorously rejected, nevertheless. Worse was to follow (see 7.3.4).

Some respondents observed that their Board’s lack of engagement was a factor contributing to later commercial failure. Again speaking before the onset of the credit crunch, product specialist SM1 recounted his alarm on hearing his Board members struggling to explain their business model to the Treasury Select Committee:

“It was very embarrassing. There were two very senior members from the investment banking side who didn’t understand [this derivative product]. They didn’t understand the very thing that was bringing the bank down, not a clue. And I’m thinking, you’d expect the CEO of Ford to know what a car was, maybe not to build one but at least to have some understanding of how it works, what it’s about. There needs to be a balance between the deep-technical-expert thing and the management thing, but there’s been a lack of [that] blend recently.” (SM1)

All interviewees referred to, at some point, the culture of their employer bank encouraging or suppressing dissent. Most found that open dissent during Board discussion of commercial decisions is unwelcome; even at Director level, challenge may only be presented in the form of incremental, constructive points of criticism. C32 offered a narrative explanation of how an organization may create, accept and finally impose on newcomers a culture of coping based on “making alternative sense” (as in Weick’s “sense-making”). In C32’s experience, two factors operated to favour sense-making: first, that co-employees across the industry acted to support organizational norms, finding that this behaviour reinforces a common sense of purpose, identity or “tribe”; second, that the reward system appeared to validate this approach:

“After a while people just get conditioned. Like ignoring the fire alarm when it goes off. So it’s ‘everyone else is doing it, I know it could be a problem but everyone else is doing it so it must be all right’. Not so much that everyone says it’s okay, it’s because everyone is doing it you just think ‘oh well this is obviously normal behaviour, this must be all right because XYZ MegaBank are doing it and they really know what they’re talking about. If everyone else is in it, we’ve got to be in it. And anyway I’ll miss out on my bonus if I don’t.” (C32)

It is significant that this respondent acknowledged that his private concern existed (“I know it could be a problem”) but fallaciously rationalised it away on the grounds that non-compliance is acceptable if “everyone else is doing it” – an example of Vaughan’s (1997) “normalization of deviance”. The final rationale he observed, and arguably the most telling one, is that the culture of his organization accepted that one may prioritise profit over ethics (“I’ll miss out on my bonus”).

The organization's culture also influences how its decision structures are created. The next subsection will consider respondents' experiences of these.

7.3.3 Organized obstacles?

Some respondents discussed how their Board appeared to design organizational structures and processes as if to limit the remit of the CRO function, to minimise its impact on the business. Thus some Directors were reported as colluding in keeping the CRO away from direct involvement in, for example, risk-assessing new products under development; or even from full reporting of risk. This approach naturally diminished the executive stature of the CRO and the significance of the role.

When organized in this way, the CRO function was deliberately removed from executive decision-making and was thus seen by some Directors to exist only as a compliance "rubber-stamp", accepting the risk for products that are already being marketed. Typical of this situation is C7's experience, including the phrases his colleagues used to describe his part in the interaction:

"In all the enthusiasm to take things to market, compliance is often seen as a sort of 'business prevention mechanism'. Some dominant personalities, maybe on the Board or in the product development area, may try to just 'win one over' on you... They'll try and make out that you're preventing the business from, you know, increasing profitability." (C7)

C7 also recalled being asked to present management information positively – that is, to arrange or even manipulate it if need be to "support the position [they] wanted to be in in the first place". He concluded that his Board was in effect asking the CRO to condone an optimism bias. Similarly, C12 recalled challenging his Board directly about a lack of dialogue or reporting between risk and trading functions; what happened next is again seen as typical of the "organized-out" CRO experience:

“My report... to the Board said that some sections of the Risk operation didn’t function as they should. Like, yes there was a CRO function, but none of the traders had to report to it. So, I did the presentation, the Board asked their questions and then there was some name-calling!” (C12)

One variant on this, reported by C19, was a Board which had gone through the formalities of creating a CRO role but then seemed uncertain what to do with the new appointee when he arrived:

“Arriving as a CRO, even as a career accountant and CFO [of a smaller company] before, I found the function wasn’t exactly embraced. It was more like grafting on an organ that they half-expected to be rejected, because ‘the CRO will always be Mr No’. They saw risk management as something foisted on them by the regulators.” (C19)

These accounts correspond with points made about access to traders during product development (see chapter 6). There is a clear similarity between the organizational technique of restricting access to product developers, and the design of a Board process that places the CRO at the end of the time-line for new product approvals. The effect of both organizational designs is to remove the CRO from effective authority over the level of risk designed into a new product. Consistent with this is an organizational approach which makes the CRO function a receiving agent for awkward or intractable risk issues. A perceived function of the CRO role at Board level was to be the first person held to the account in the event of a failure of product or of a risk control:

“If something does go wrong, one of the first people in the firing line at the Board table is the CRO.” (C15)

This was perceived to be the consequence of when real events interrupted sense-making which had previously prevailed. In a similar vein, even the most seasoned CROs were constantly anxious about being ambushed by the emergence of previously undisclosed information:

“On legal risk obviously there’s always a fear as a risk officer that disclosure is full enough, you know, that a legal opinion was given on facts that weren’t quite as presented.” (C18)

If one intended function of the CRO role (at least by the regulator) was to enable an in-house challenge to automatic approvals for new product risks, in C15's experience this function was not effective. He found, given a new product which was practically "ready to go" but not yet shown to him for approval, that this Board had an overriding faith in econometrics, together with an unwillingness to listen to his "intuitive concerns". It was a Board-level organizational

"reluctance to admit things.. if [the product] has a risk model in place, you've invested millions of pounds in this, so therefore it's 'I'm going to use it no matter what, even if it's telling me something that feels intuitively not quite right'." (C15)

He "found it ironic" when one product subsequently failed and, as CRO, he was then held responsible by the Board for not intervening earlier and more forcefully:

"The Board said 'why didn't you tell us something was wrong?'"(C15)

This experience is consistent with other respondents who described the role as created by the organization as a dumping-point for "difficult" risk issues. C19 and C20 both pointed out that the effectiveness of any challenge to the Board on a "difficult" issue depended on how well they could manage to anticipate the level of support they would get from above.

C20's experience indicated that even a direct reporting line to the Board could introduce an organizational challenge, in another form. Attempting to push back when the Executive Board disagreed with his proposals for reform of risk reporting, C20 realised that he had been denied access to a potentially vital group of senior supporters. This was, as he said, rather a case of "be careful what you wish for"; by arranging for him to sit only with the Executive Board, the organization had cut him off from appealing to the Non-Executives – those part-time Board Directors whose role is (again, in theory) is to challenge risk governance decisions made by the Executives. C20 recalled discovering, too late to save himself, that

“I did not have a direct reporting line to the Non-Executive [Directors]. I reported to the Executives, which in practice means that you put yourself at risk as soon as you raise challenges to them.”
(C20)

7.3.4 Force of personality and affect

When C12 referred to “name-calling” as a feature of Board meetings he attended, he identified with a recurrent finding, conflict between strong personalities in senior management. As chapters 5 and 6 have established, the restraining role of the CRO is naturally in tension with the ambitions of sales-side employees. Add to this a commonly noted difference in personality type, which the organization rewards – that sales-side staff are given bonus incentives to take risks, whilst back-office people are paid fixed salaries to be cautious – and it may be predicted that confrontations will occur.

Less predictable is whether such confrontations might be expected to continue, let alone arise, in the Boardroom. The Board should offer a forum for rational and thoughtful debate about strategic risk issues: naturally it is of interest to the present research to see whether respondents experienced this to be the case in reality.

One of the most feared, and commonly recalled, CRO experiences was the interpersonal conflict started – apparently deliberately – by a Head of Department (such as Trading). Some respondents interpreted this as a strategy to deflect attention away from the presence of a non-compliant system or behaviour²⁸. C15 found sales-side colleagues “assertive” in avoiding engagement with his questions about new products.

Descriptions of the reality of the Boardroom often included a component of affect (that is, emotion) in decision-making, which came as a surprise. This component might typically take one of two forms. First, optimism bias associated with successful pursuit of profit during a rising market. This form of

²⁸ This is noted by Cohen (2001) as a form of gaming strategy used by the guilty to deflect attention by attacking those who have made a fair accusation of wrongdoing (“violent innocence”).

collective euphoria is of course already familiar economists and has even seen some attempts at econometric rationalisation, such as Mackay's (1841) 'greater fool' hypothesis. A common experience was for a CRO to find their "reasonable concerns" (C15) being swept aside in order to expedite marketing of a new product. Also common, but a darker side of affect, was to encounter a colleague's display of anger or aggression in place of rational argument. This typically occurred when a CRO attempted to confront the head of a commercial department.

Although an extreme experience of affective response – with a life-changing outcome – the rationale of the following episode for C20 is clear:

"There was a product team running away with itself and I was attempting to intervene. People had been given sales targets for switching customers from deposit accounts to corporate bonds. The customers who were switching didn't understand that this meant they were actually now taking a capital risk, they just thought they were getting a higher yield in a new deposit account. For me, it was like going behind enemy lines, that's the best way to describe it. So I went and put myself in the front office, observed the frontline staff doing the disclosure. And I watched the client, their eyes going round and round in circles, they didn't understand it – so yes, you could give people a bit of paper with the written disclosure on it but they still didn't understand it. But next thing, the person who was running that operation was given a title of group director of risk, i.e. over my head as a risk officer at the business level, despite their having no experience of risk management. And just to make the point, they then leant across the Board table and pointed at me and said 'I'm warning you, don't make a fucking enemy out of me'. Oh yes, and then I was fired."

(C20)

This illustrates the extent to which a forceful sales-side individual may influence management process – and even, in this case, apparently subvert the risk control framework. All respondents acknowledged in some form, though with less extreme examples, that a prime driver of the Board's collective response would often be the individual on the senior management team who had the most forceful personality. Whilst one might intuitively expect this person to be the highest-ranked Director, such as the Chairman or Chief Executive, CROs recounted that in practice the "loudest voice" was usually found to belong to the director who had the most direct interaction with financial markets – that is, the head of front office, responsible for trading, sales, and/or marketing. As C12

said of his Head of Trading:

“I mean it was always him, the minute you went in there, [the business] was his fiefdom. Of course, but I mean we all knew that!”
(C12)

The commercial origins of this arrangement have already been explored in the historical notes in chapter 2. It now appears that in the Boardroom in many banks, the greatest respect was accorded to those who brought cash into the business. Over generations of the business, and certainly entrenched by the time of the present research, the trader-Directors had come to realise that they enjoyed an informal but generally accepted primacy. Faced with a possible obstacle in the form of a CRO raising an objection in the Boardroom, a head of trading would make it plain that commercial priorities were absolute, and expect this view to be supported. As a new arrival, the CRO’s objections would be discounted; C12 found that his head of trading “would tolerate no questions of any kind”.

C12’s account is notable as an experience at the extreme end of “creative compliance” in derivatives mis-selling before the 2008 crash, with a head of trading confronting his Board without fear of consequence. Although C12 described a vivid scene, his conclusion was nevertheless a common one among respondents: that faced with a “mad genius” (C12) who happens also to be making enormous profits for the bank, the Board is unwilling, or even helpless, to question what is happening:

“He ran bedlam there, everyone knew what he was like... I mean he basically behaved like a maniac but people had no idea how to stop him.”
(C12)

This is not to say that such a situation was normally promoted by trading floor interests. Although heads of trading are singled out by respondents as particular, even systemic, objects of fear and distrust, within the aggressive culture of financial markets it was not only the fee-generative managers who were capable of this level of dominant influence:

“Very often if you have a dominant CEO, everyone is pretty well frightened to say anything.” (C27)

This does not mean that other Directors, such as the Finance Director (CFO), were seen as without influence: indeed, many respondents cited the CFO as their most important ally in the Boardroom. However, a resistant CEO would be unlikely to support a CRO who questioned the Board’s established stance on acceptable risk-taking. The presence of a “dominant” CEO, says C14, could mean that

“it’s like, anyone that says ‘hang on a minute’ is immediately put in a straightjacket and thrown away.” (C14)

It is appropriate, following the last two examples, to note that respondents often recounted personality clashes in terms of emotion and even madness. It is striking that conflicts between senior managers are frequently narrated in terms of “forceful” or “mad” individuals coercing the support of the other, “calm” or “rational” senior managers, both in and out of the Boardroom. This polarising of “mad” versus other parties is partly attributable to a simple delight in the act of telling the story, a common cultural experience among City workers, as noted in Chapter 4. It may also indicate the prevalence of an underlying anxiety which informs how CROs make sense of their circumstances – that sales people, in particular, are simply “different” and cannot be managed by rational argument. On receiving contradictory information, or irrational appeals to ignore ethical considerations, the CRO might feel the need simultaneously to deny their influence as “mad” and yet to have to comply with their wishes, apparently for fear of personal reprisals.

One might expect the Board, which should be a forum for thoughtful discussion and rational debate, to offer some protection from such assertive and personal forms of interaction. However, for some respondents, rather than offering shelter, the bank Boardroom was a space where these confrontations were permitted to continue and even to escalate, as C7 recalled:

“It’s very easy for the trading side to ‘pull rank’ on you at the Board table. The guys that run the derivatives books came up with huge and complex models because really only they can understand it, they said. So now my question (back to them) is, do you *really* understand it? Because that’s the question that a risk function has to ask. And that’s where you get very confrontational.”
(C7)

After a year’s employment with the bank, C4 was still expecting support from the Finance Director (CFO). Instead, he attended the Board meeting only to find the “not pleasant” experience of an expected ally turned directly against him. He was startled to find himself under personal “attack.. simply for not being in the top performance quartile” (C4). It took, he said, “some courage” to regain his composure and counter-argue:

“It’s not pleasant when someone’s attacking you simply for not being in the top performance quartile. It takes some courage to say, ‘actually at this point in the markets we wouldn’t be expecting above a 10% return because our cycle is not the same as our competitors’. I had the CFO tear me apart for that, though I held on and said ‘you’ve got to be more realistic about it, the only way to change that would just be reckless, what are you going to do, fire me?’ And then a couple of weeks later I got a call from the CEO, very short call, he just said ‘we’ve fired the CFO’, nothing else!”
(C4)

Although alarming, C4’s evidence also suggests that a tense interaction with the Board may yet produce a supportive outcome – even if, in this case, the support did not come from the expected direction. C4 personally concluded that a CRO entering the Boardroom should not expect to find their position and judgement supported by the CFO. In his personal analysis of what had happened, C4 concluded that the Finance department would always ultimately seek to align itself with the “sales side”, since Finance is the source of the cash which the sales people need to fund trading. In this incident, the CFO appeared to have identified the CRO as a back-office stereotype, assumed to be commercially subordinate to Finance.

Another CFO encounter, reported by C27, supports this. In this incident, the CFO made it clear that Finance department was primarily interested in making

cash available to the business; new approaches to risk management were only useful to the CFO if they supported this aim:

“The Finance Director picked up my presentation [for a new credit risk system] and flicked through it and said ‘I’m not really interested in this level of detail. All I am concerned with is that we get approval so I can lower regulatory capital. Let me make myself absolutely clear, if your system doesn’t allow me to go to the regulator and show him why we should have lower capital then I’ll throw the fucking thing out the window.’”
(C27)

As these experiences indicate, especially for those CROs without direct Board access, and so reliant on their CFO as their channel of communication to the Board, there was little encouragement that their concerns would get a hearing. The expectation was that one might just as easily be “undermined and not supported”, and quite possibly “fired in consequence” (all phrases C24). Faced with such obstacles, CROs might be expected to consider various methods of pushing back and reasserting their own point of view. This expectation is now considered.

7.4 Overcoming practical limitations on exercising power and authority

7.4.1 The need to develop strategies for exerting authority, and for survival

Taking into account tensions with the FSA, and resistance from the traders and the Board, it appears that all CROs have, at some point, an experience of discovering that they do not have the power or assumed authority that they expected to have. With no generally accepted level of authority for CROs within banks, respondents described having to earn respect on an individual basis. Whilst there was broad familiarity with the CRO job title, personal experiences indicated that they were expected to achieve authority and recognition by force of personality, or by some other acceptable demonstration of technical prowess. As C27 put this:

“How much authority you’re perceived to have is a function of how you approach the (CRO) job.” (C27)

This begs a question of what strategy of behaviour the CRO might adopt to earn respect for authority. Every CRO had a view on this, although the practical suggestions varied from one commercial setting to another. Some common themes are presented in this section.

Many CROs adopted a strategic approach of demonstrating, by word and action, a willingness to “fit in” with others’ conception of what the business of banking is about. This might mean intervening to help to complete a commercial deal. Routinely, it could mean offering practical support for product marketing activity, which might include contract structuring, risk-testing, legal and regulatory approvals. Many regarded such involvement as divided between “real” and “symbolic” activities. The latter might include performative “rubber stamping” of products which the marketers had already approved for sale. The key was to demonstrate enthusiasm for commercial activity:

“If you behave as if you’re there just to count the beans, perhaps you’re not going to do yourself any favours. If you show you’re there to add value in terms of new product design, maybe you’re accorded greater respect.” (C17)

Again, the use of conditionals here - “perhaps” and “maybe” - does not imply confidence in the outcome of this coping strategy.

Nevertheless, the CRO would expect improved engagement from colleagues following a strategy of presenting themselves as integral to the enterprise management team (as opposed to a back-office, cost-generating interloper). CROs concluded that they could be an acceptable presence among sales-side bankers for as long as they might be identified as an individual with interests in commercial, fee-earning activity, rather than a bureaucrat.

In this regard, two respondents were notable as having become CROs by way of commercial experience – that is, from within the ranks of traders. Their resulting

“insider” knowledge was described as a distinctive asset and a source of authority:

“The best CROs would have to be like me, with a background in trading, so they’re not people who are unaware of the tricks the traders play.” (C25)

These “tricks” were reported as taking various forms, but most commonly involved the sales-side filtering of information. C12 discovered that his reports were edited between his writing them and their appearing in the Boardroom:

“My report was going to be circulated (in full) but when it came to the Board meeting it appeared on the table as an executive summary. So I did the full presentation!” (C12)

Having adhered to his principles, C12 was rewarded with a lively Boardroom debate but was also “called some [rude] names” by the Director whose editing he had dared to challenge.

Just as documents might be re-presented in this way, so too the CRO might find their role described differently when it was being communicated by heads of trading to their own staff on the trading floor. For example, C12’s head of trading told front office staff that although there now was a CRO function, “none of the traders had to report to it”; this sabotaged any chance of getting traders’ attention, let alone their co-operation or compliance.

For the CRO whose attempts at positive culture change towards risk-awareness had failed, there came a time to decide on the best way forward. Facing daily the apparent possibility of provoking violent, career-threatening disagreement with a simple compliance request, CROs considered various strategies for career survival and daily coping. Their perceived overriding need was to be seen as an acceptable, and preferably useful, member of the management team:

“There are trade-offs about creating self-respect in the role, making sure that people take you seriously as an independent voice. You’ve got to have something to bring to the table over and above what they were already doing.” (C6)

The consensus emerged that a CRO had, in effect, three options, which will now be explored.

7.4.2 Examples of survival strategies

The first strategy a CRO might try was to mediate their way out of a conflict. By being polite and non-confrontational, the CRO might maintain personal integrity and succeed in presenting compliance demands in alternative, softer terms. Personal confidence could be expressed in forms other than an aggressive, direct challenge to a head of business; some saw the benefit of promoting a longer-term view of risk-taking, to move co-Directors' expectations beyond immediate results. The effective CRO saw themselves as knowing how and when to assert authority without having to force the appearance of doing so. This could be presented as a personal "philosophy of risk" (C20), as in:

“Now I don't really have a very high personal risk appetite but I do have the confidence to manage the risks. Risk is a vital part of humanity, you know, onwards and upwards.” (C20)

It may alternatively be disguised as the low-key pursuit of elusive audit facts,

“just going in and checking for ‘unknowns’, just testing where you think there may be a problem, just going in wherever you think there seems to be a ‘something’.” (C15)

It was accepted that “doing nothing” was not an option, as this might readily be seen as condoning others' bad behaviour:

“It's more than just having the confidence to ask a difficult question. Sometimes just by being there and *not* asking, you have been captured by the process, and now you're part of the problem and not the solution.” (C4)

An essential survival skill for this first, mediative, strategy was therefore to develop diplomacy and alternative languages to the conventional, confrontational

dialogue of demand and refusal which traders were accustomed to use as part of “pushing the deal”:

“When you’re faced with a front office or marketing arm that’s trying to do something, saying no is about the most difficult thing you can say. So you learn to say no differently. It’s the way you say no that counts. Never actually say no. Say ‘when these four rather reasonable conditions are met, and if you still want to do it at that time, then I can see no reason why we couldn’t proceed’.”

(C19)

CROs who developed interpersonal skills beyond the mere need to secure an audit return recognised the practical difference between the letter of a regulation and implementing rules in practice. In this respect they internalised a ‘street-level’ pragmatism already familiar to overstretched regulatory agencies around the world.

The second strategic option was to take the same initial approach as the first, but to allow a compromise on its principle by being prepared to negotiate away certain demands in return for at least partial compliance:

“I’d like to believe that CROs have come in not to, to put it crudely, tell lies to the regulator. There’s a big difference between the Board saying ‘sort us out so we’re OK, you can talk to the FSA’ or giving it to you more like an ultimatum, sort of ‘we’ll only do item 6 of your recommendations’ – in which case your only choice really is ‘do I leave now?’.”

(C5)

The third strategic response was essentially to accept that one had been captured by the process and to try to maintain as much dignity as possible. Such “going with the flow” (C11) clearly indicated to others in the Boardroom a certain flexibility of approach to ethical concerns. This approach carried the highest risk of both formal sanctions and heightened stress and was therefore only a coping strategy in the sense that the coping consisted of a surrender of personal responsibility in the face of a perceived greater force. This form of cognitive coping could entail disassociating oneself from consequences. In this respect it recalls criminal evasions of guilt (Sykes and Matza, 1959) which attempt to separate a non-compliant act from its ultimate effects on customers. CROs

accepted that there could be a betrayal of role here but some saw merit in “waiting it out on the basis that you may get away with it if nothing bad happens on your watch” (C20).

Some justified this final strategy of non-engagement on the basis that it merely supported a business ethic of “the way we do things around here”:

“See no evil, hear no evil, you know, everything’s fine that looks OK. Why? Because that’s what business wants to hear.” (C18)

Sustained denial of responsibility might be seen as justifying itself by repetition or in terms of instrumental conditioning, or even ultimately as a ‘Game Of No Game’ (as noted by Cohen and Laing). In this game of cognitive reframing, any attempt to refer to the existence of a business uncertainty, or of a fault in risk modelling, or of a colleague’s behaviour as unacceptable, would lead to the complainant being ejected from ‘the game’, meaning the job. One CRO who adopted this approach recognised its ethical emptiness:

“You just keep on providing everyone with what they expect... In fact, it’s more than that: You not only deny the something you’ve done, but you’ve got to hide your denial.” (C12)

Others rationalised capitulation as a realistic response to the overwhelming complexity of products, and the task of controlling them; that is, that systemic problems had now outgrown the capacity of CROs to comprehend, let alone intervene to manage, them:

“There are many flavours of CRO but more than ever now I see the sort who sort of, were good at the start but the problem now is just too big for them.” (C4)

7.5 Conclusion

Although regulatory theory suggests that power and control are issues often prescribed by formal status, the current research points to CROs having to attempt to exercise power by making a reflexive assessment of the power

available to them. They gauged and interpreted available power according to the responses they received from colleagues after attempting to exercise it. Such behaviour might be interpreted as a practical act of sense-making (Weick, 1993). It was an empirical means of establishing how much power they might have available, as defined by the perceived “traction” they might have over some challenges, as indicated by colleagues’ supportive or dismissive responses to proposals.

For many respondents the defining practical experience was of a particular moment, early in office, at which a senior manager, typically a head of a trading division, would mount an aggressive challenge to the CRO’s authority. How you responded to the challenge would set the tone for future dealings with other senior management, possibly getting “very confrontational” (C7).

The outcome of such a confrontation in each case would be decided by how the Board reacted: either providing or withdrawing support for the CRO’s assertive position. Board support, or the absence of such support, would not always be immediately apparent, and in some cases only became known by proxy, as for example when the CRO saw traders continuing to ignore an earlier warning.

Speaking before the market shock of 2008, one respondent had suggested that without an upgrading of role, scope, status and reward, the CRO office would fail to fulfil any real function, let alone all the expectations placed upon it by public opinion and regulators. In reality, it was evident to most respondents that, following a short period of goodwill on arrival in office, they would be expected to fall in line with commercial expectations of the role.

A CRO might respond by attempting to build strategic alliances with Board members, although these might backfire. Most CROs recognised that it could be a career-ending move to mount an unsupported challenge on the Board’s authority. Few were granted sufficient senior access or authority to do this. Some CROs overcame this by coopting a middle-management colleague from the trading side of the business:

“After I managed to get a senior product engineer on side, it reduced the level of push-back, because we could talk the (traders’) language.” (C15)

The experiences recounted in chapters 5 – 7 offer new insights into the reality facing a CRO. CROs’ ways of rationalising conflicting demands have been explored, making sense of what the job requires when senior managers’ instructions seem to be compromised by self-interest. Some responses appear to have been predictable within existing models of risk perception: For example, a CRO’s decision whether to report an anomaly may be affected by a powerful dread of personal consequence.

At a personal level, a consistent picture emerges that the newly-appointed CRO is typically confident of their ability to make positive changes in the organization, engendering a new culture of compliance. This is then commonly found to have been an optimistic illusion. The contrast between early good intentions and later pragmatic adjustment may be summarised by contrasting a respondent’s views of the “before and after” outlook, as C7 did:

(On appointment): “The CRO role should be about the ability to look beyond fancy-looking charts and be willing to rock the boat. It’s about shouting loud enough to be sufficiently heard in the organization.” (C7)

(Subsequently): “A CRO may just back off when there’s a major risk or issue for the business, then their position is totally weakened, they’re just totally ineffective in that role. I’d say yes, CROs have failed in that we just weren’t as assertive as we should have been.” (C7)

The experienced reality is that informal groups, steered by forceful traders and commercial Directors, subvert the formal best intentions embodied in the regulatory framework and the CRO role itself. Some time after arriving, each CRO experiences a moment at which the extent of others’ coping compliance becomes evident to them. This coping may vary between a positive approach, with some constructive engagement with the regulator, to, more often, a redefining of the CRO role as primarily responsible for minimising regulatory capital. CROs’ initial motives of ethical intervention, faced with inflexible (if

informal) profit motives in the organization, degenerate into an agenda for pragmatism. Day to day this plays out as a game of self-preservation and avoidance of open conflict.

The final chapter will take a broader view of empirical findings to discern patterns which confirm, or differ from, earlier theoretical predictions; and the implications of this, both for present understanding and as an agenda for future research.

CHAPTER 8: DISCUSSION AND CONCLUSIONS

“Wanting to do the right thing is not the same as doing the right thing”

(Nielsen, 2011)

8.1 Introduction

The research interview findings in Chapters 5 – 7 build up a vivid picture of the encounters between risk managers and commercial bankers. This encounter may be characterised as a collision of two cultures: On one side stands the CRO, who personifies a hierarchical audit process; on the other are individualistic traders who hurl abuse at anyone who interrupts their selling. Reflecting on these cultural opposites, this final chapter will review findings to discuss the extent to which, as heads of banks’ risk management, CROs succeeded in their function of challenging excessive risk-taking; or whether they were drawn into accepting and even legitimising a prevailing culture of creative compliance.

As observed, there were three routes by which the CRO might be drawn in to the sales-side culture: through interactions with the FSA’s case officers, with the bank’s sales staff, or with the Board. Having examined evidence of CROs’ interactions with each of these groups in turn, they are now considered together in addressing the broad question: To what extent did the risk management function challenge organizational conduct as found?

The research topic initially identified the possible existence of coping in banks responding to the regulator’s demands for risk reporting; considered whether, if found, such responses would be analogous with coping responses noted in other sectors; and sought to characterise CROs’ coping with related risk reporting. Issues are identified in three related areas, which are now discussed in this chapter: The nature of the regulatory regime; the nature of organizations; and how a senior manager may attempt to make sense of seemingly conflicting priorities.

Moving on from the starting-point of the research findings, this chapter will finally consider how new understanding of the CRO role suggests ways of making the role more effective, or possibly of replacing it with a better alternative.

As noted in Methodology in Chapter 4, one unusual and unforeseen aspect of the present research has been its timing, which by chance was contemporary with major turbulence in financial markets. Although the presence of a financial crisis was not factored into the research design, which took place substantially during 2006 – early 2007, the nature of the crisis, following the failure of risk and regulatory controls to prevent a collapse in liquidity, is clearly a topic of direct interest to the present research respondents.

It is evident, though discomfiting to acknowledge, that the primary research work ultimately derived considerable (and unpredicted) benefit from taking place during the event of a global banking crisis. The advent of dramatic events in financial markets inevitably coloured the personal perceptions held by respondents during the latter stages of the research (2008-9). This does not alter their resonance, nor the consistency of the picture which emerges: it is also appropriate here to re-state that the aim of the research was not to calibrate coping but merely to establish its existence among CROs and to explore its possible manifestations. Concurrent events in the financial markets might be expected to have produce skewed – and typically, embittered – accounts from CROs whose experience of any tensions in the role might be especially acute at the time. To such concerns, this researcher would indicate the consistency of findings which nevertheless emerged; and that a sample of 35 (out of a possible 70) respondents gives ample internal triangulation to the findings.

After interviewing approximately half of known UK bank CROs, whilst some openly expressed bitterness at their predicament – and, in fairness, others displayed varying degrees of *schadenfreude* at their colleagues' fate – these are inflexions of tone which do not contradict the consistently reported behaviour which emerged. Although the market crisis was beginning to create job losses in banks during 2008, immediate pressure on CRO employment was not found to

be a factor at the time of the interviews: Only two respondents self-identified as being on the point of leaving their (CRO) jobs: one (C20) was interviewed shortly after being ejected from his job, as his dramatic account of the proceedings makes clear; one (C19) moved a week after the interview, and displayed no resentment about this, as moving to a CRO role in another, non-banking financial service provider. It would be wrong to infer a pattern of job insecurity from these two isolated cases, although on a longer hindsight view, CROs' positions have become more vulnerable since – by 2012, at least 10 of the 2008-9 respondents are known to have moved to a new role, and not all of these voluntarily.

To dismiss the present (possibly unpalatable) research findings as merely the product of the “market turbulence” of the time would be to ignore CROs' underlying concerns about the prevailing asymmetries in banks' risk reporting systems, which the present research had identified as an issue before the crisis struck. The problem pre-existing at the time of the crisis, though confirmed by respondents as amplified by it, was that CROs were given nominal power, but without the practical authority necessary to exercise it to introduce more responsible risk reporting practices.

To recapitulate: A bank CRO may be seen as the single employee most responsible for reconciling conflicting concepts of the function of risk management: on the one hand, public protection, on the other, private profit opportunity. The CRO simultaneously has to maximise return on risk for the employing firm and also alert the regulator to excessive risk-taking. In practice, as reported by CROs, these responsibilities are often irreconcilable; the more so when incentives are skewed to dissuade public risk reporting. Placed in a new role with no pre-existing processes or methods, the CRO might be predicted to devise their own methods of dealing with this conflict. Caught between demands for compliance and self-seeking commercial interests, how else might the CRO be expected to respond?

8.2 Constraints imposed on the CRO from three directions

It is apparent that banks and the FSA placed an unbearable weight of expectation on the CRO role by, in effect, mapping the function of risk reporting onto the person of the CRO. Whilst the creation of this senior role implied considerable power and authority, the reality as experienced by CROs was that the role was subject to strong constraints. Some of these constraints were predictable – such as a natural resentment of a “newcomer” discipline among more established commercial practices. Others were less foreseeable; such as the Board denying support, or the practical impossibility of asking the FSA for help.

How far a CRO could succeed in achieving their role depended on how they responded to constraints imposed by the three most proximal groups of actors, as researched: the regulator’s case officers, the bank’s sales staff, and the bank’s Board of Directors. This section considers the relationship with each group, to draw headline conclusions as to the value of the research.

8.2.1 Constraints in interactions with the regulator; efficacy of the system of regulation

The first interacting group was the regulator’s (FSA) case officers – that is, the regulatory agency staff whose task was to come in to banks to discuss and evaluate risk controls. Case officers often relied upon bank staff to produce the data they needed, and to explain how products work.

Regulatory theory argues that a system of enforced self-regulation allows a poorly resourced regulator to capitalise on regulated organizations’ internal governance mechanisms and so to control risk more efficiently; this system can resolve problems of information asymmetry and regulatory inflexibility. Any failures of co-operation, again in theory, may be remedied by enforcement action. Yet, as the present study indicates, in practice enforced self-regulation fails to control excessive risk-taking by bankers. The evidence offers a number of clues as to why this occurs.

First, incentives in the banking sector are not aligned to support regulatory demands and expectations. Rather, banks' reward structures contain a significant skew: Traders' risk-taking is rewarded with short-term bonuses, whilst back-office risk managers receive only fixed salaries for long-term watch-keeping. The net impact is a dominant commercial pressure, producing creative compliance in various forms. As seen in Chapters 5 and 6, these forms include: manipulating reported numbers; "stage-managing" the regulator's visiting staff; exploiting regulatory staffs' inexperience and lack of technical knowledge; and waiting for the "revolving door" to remove troublesome enquiries. Such activities cannot be conducive to building a constructive relationship between regulator and regulatee.

The FSA's case officers meanwhile were typically regarded as struggling to understand technicalities, and having too little time to make thorough inspections. Bankers often observed them to be short-term appointees in their role, and content to use pro-forma auditing as a substitute for proper enquiry into anomalies. Any of these factors might dissuade the CRO from approaching the FSA for support with an enquiry into a point of concern. FSA representatives' perceived lack of understanding also discouraged CROs from raising genuine concerns. For every CRO who was willing to volunteer concerns to the FSA, another would advise withholding information to limit their exposure to perceived regulatory risk.

Even when the CRO might need to work with the FSA, as when wanting to seek the regulator's guidance on a new point of concern, the relationship was seen as unreliable. Rather than exercising discretion, the FSA officer was seen as likely to run away with the evidence of wrongdoing, only to return later threatening to use it as the starting-point for an enforcement action. This expectation by CROs turned the FSA from a potentially welcome ally into a hazardous point of contact. To add to the hazard, any CRO who approached the FSA might be regarded by senior colleagues as admitting defeat in the role, or as betraying their loyalty to the bank – in either case a career-ending move. Given these constraints it is not surprising to find that many CROs did not regard the FSA as a desirable or approachable ally in the task of preparing public risk reporting.

Over time, ways of avoiding contact with the FSA could, and did, extend to include the selective use of risk models and source data.

Despite these concerns, routine and pre-emptive gathering of information by the FSA was accepted, though rationalised as a friction cost of business, and with resentment at the wasteful duplication of effort involved in filing multiple reports of transactions.

While it would be wrong to infer that a CRO is always actively complicit in subverting the regulator's requests for information, in many banks minimally informing or "handling" (stage-managing) the case officer were regarded as normal ways to handle such a request. Historically the regulator underestimated the influence of informal organizational culture in determining how a bank responds to attempts to impose new risk controls; CROs by contrast intuitively understood that senior management sets "the tone... that translates into decision-making" (C9). If the FSA represents well-intentioned "rules as drafted", the CRO is far closer to the realities of "what's going to happen" (C27).

As a summary point, self-governance patently fails when the regulated sector perceives itself to have more power than its regulator. Banks may suggest excuses and rationales for non-compliant behaviour (such as exceptional productivity, or high employment, or allegedly superior business acumen). Ultimately, though, they are more or less careless of consequences, secure in the knowledge that the government very much needs their revenue contribution, and that their business will in any case outlast any current government.

8.2.2 Constraints in interactions with traders

The second interacting group is the organization, as represented by its most commercially energetic members, the sales staff. An organizational perspective helps to reveal what happens in firms whose traders' primary objective is to make money almost regardless of other forms of cost. This premise often appeared to be impossible to challenge, especially from a new role such as the CRO which lacked an established and direct connection to levers of power.

CROs who arrived in office expecting to be able to secure the co-operation of traders to compile risk reports were disappointed. The common experience was that one could summon traders (usually after some resistance) but not expect to hold their attention or to gain solid support for any initiative which did not involve making money. Risk management is usually defined and structured as a cost centre activity in the bank, employing staff on modest salaries. Trading, meanwhile, is recorded as a profit-generative activity, detached from its overheads, and paying out large bonuses to sales staff. There was thus no apparent cultural or pragmatic incentive for traders to concern themselves with the risk office. The effect of these differing approaches to risk and reward, between two departments within the organization, was to set up traders and CROs in opposition to each other. CROs' attempts at rational challenge to sales-side informal behaviour often failed simply because established ways of working were so deeply entrenched.

CROs at least succeeded in seeing through the illusion (or delusion) of sales reporting: that the respect accorded to high-grossing sales staff was based on "headline figures" – meaning sales only, not including any overheads or even direct costs of sales. Remarkably, the biggest factor that traders could ignore was cost of capital (that is, the cost of keeping the business in enough funds to be able to carry out trading activities). For the CRO, this systemic skew with regard to profit and loss created a harsh and plainly unreasonable consequence: daily pressure from the front office to make "discretionary" adjustments to reported risk figures.

Manipulating risk reports so as to lower the regulatory capital figure can, and does, increase real risk to the public – but at the same time can make a CRO popular with sales-side staff. In the event, few CROs are willing to stand alone to challenge this embedded risk culture. Their reluctance is understandable when one observes first-hand the characteristic contrast of personality types: traders, bullish and intuitive, who aggressively reject a CRO's "intrusion"; CROs, rational and civil, will not respond in kind to a personal provocation. More than this, banks are structured in such a way that risk management is divided: Traders

are installed to make money; risk officers are there to protect it. To traders, this arrangement is an active deterrent to accepting as legitimate the CRO's claims to their attention.

As well as the different reward systems already noted, CROs also faced more literal, physical barriers: For example, risk managers' back offices could be physically remote the trading floor, or even in another building entirely; and risk staff could even be denied access to trading floors. Such organized obstacles to good practice reflect an underlying culture in which loyalties are clearly seen to be allocated to one of two informal groups, typically framed in terms of front office or back office. The front office "way we do things" is reinforced by trading team heads who prefer to recruit assertive salespeople. Back-office loyalty meanwhile is to the function of reporting, with processes seen as more significant than commercial outcomes. Traders' simple aggression challenges the more passive back-office personality types to disagree, and tends to win. In cultural terms, trading activity imposes a hierarchy of expectation which demands, and receives, preference in allocation of resources and rewards. CROs suffer under one other powerful disincentive: that an attempt to exercise true authority by challenging traders' conduct might lead to losing one's job. An analogy comes to mind: the CRO entering the trading floor is like the lone sheriff in a lawless Wild West town, surrounded by misbehaving cowboys, pleading with them to change, but hopelessly outnumbered and so an object of derision.

In summary, although the CRO role had nominal authority over traders, in practice the CRO's power was constrained by an organizational culture which protected the interests of traders above all other functions. To exert influence, a CRO needed senior allies: Directors' support, or lack of it, could be a decisive factor. The influence of Director relationships is now considered.

8.2.3 Constraints in interactions with Directors

The third constraining group is the Board of Directors, to whom CROs might expect to be able to turn for support in advancing plans for risk governance. To

the surprise of many CROs, senior managers were often found to represent sales interests, if anything more vigorously than the traders. The absolute dominance of a culture of profit-seeking, in the Boardroom as on the trading floor, meant that a CRO's plans for greater transparency in making risk-based decisions could be dismissed as irrelevant. This culture has, if anything, hardened in recent years as many banks have completed a transition from traditional activities (simple deposit-taking and lending) into complex products and playing the markets with borrowed or virtual money.

Against this background, the authority of the CRO was open to question at Board level because the CRO role itself was a novelty, not yet having acquired a clearly defined status. This lack of definition provided an excuse for Boards to sideline risk management, for example by having the CRO report to the Board only through another Director's office. The Boardroom interests of Finance Directors and CROs, again which might be expected to coincide, were sometimes directly contradictory. In an apparent self-contradiction, Boards who had established a CRO role as a technical "tamer" of exuberant risk-taking, were content to stand by as CROs' functional norms were subverted – whether by coercion, threat, or outright fear for survival.

Thus, whilst one might expect a bank Board to support its own appointed CRO's requests for action, this expectation was not fulfilled in practice. The nominal power of a CRO, as Board-level or Risk Committee executive, appears compromised in several ways. For example: procedures for rating risk in new products sometimes included CRO approval only as a final formality after commercial Directors others have already decided in favour; a CRO present at a senior management meeting might be discounted as a "technocrat", or taken out into the corridor and told not to ask asking awkward questions; CROs' objections generally might be dismissed on the grounds that back office people cannot be expected to understand the organization's core purpose of pursuing profit ("what we do here").

Considering these factors all together, the CRO could be in an uncomfortable position organizationally. Structures of authority and incentives were so

asymmetrical – that is, stacked against the CRO – that any chance of a CRO generating “creative tension” or a “challenge function” as a strategy for problem-solving was in practice replaced by tensions of a destructive kind. Without unequivocal support from the Board, the CRO role lost its claim to authority in the organization, restricting the CRO’s scope for action and reducing personal efficiency as an agent of risk governance.

Facing this, what was a CRO to do? The following subsection reflects on how CROs responded to these constraints, and the wider effects of these responses.

8.2.4 Responses to constraints

Facing constraints in these three essential working relationships, CROs conceived that they faced a three-way choice: To challenge abuses directly, at the risk of sudden loss of one’s job; to engage gently with any abusers in an effort to persuade them to adopt more appropriate risk definitions and practices; or to try merely to survive one’s fixed term in office, all the while hoping that no major control failure would expose this as a “sell-out” to trading interests.

A CRO who pursued the direct challenge strategy might expect to forfeit their job (as did C20). Most described pursuing variants of the second and third strategies; these were both conceived as “sense-making” alternatives, since the CRO was preoccupied by constantly having to assess which parts of the risk management task would be regarded by colleagues as most important. A surprise for many, in terms of job function, was to find that their colleagues most valued them for their time spent creating figures for regulatory capital, including if need be manipulating input data to achieve this.

Throughout banks, self-restraint tends to weaken when the rewards for success are seen to outweigh penalties for failure. For CROs this meant realigning their own risk perception so as to support banks’ view of risk as opportunity. Decisions required amoral weighing up of career impact versus probity (not “should I do this?” but “will I be prosecuted?”). For many CROs – and many bankers – it was appealing to serve the term of their contract, characterising

themselves as foot soldiers who must survive in surroundings which were simultaneously both hostile and rich with opportunities.

In summary, the balance of power was tipped against the role of CRO, who faced informal yet entrenched interests. At least in the early days of the CRO function, colleagues' "silo" approach to risk management was often found to militate against the creation of a single business-wide view of risk. In the worst cases found, the CRO function was reduced to ritual approval of decisions already made elsewhere by product developers and salespeople.

The present research has sought to build on understanding of how regulated organizations respond to regulators' demands for compliance by asking UK bank CROs to give personal, informal accounts of their experiences. Although their job titles and the nature of traded products differ, it might be expected that bankers would display similar coping characteristics to business managers already studied in other sectors. Accordingly, the next section compares real experiences with academic predictions, reflecting on where the findings concur or differ.

8.3 Empirical findings and the literature

This section will reflect on how well the literature predicted what was actually found, considering the three analytical perspectives identified in Chapter 3: theory of regulation, of organization, and of risk perception.

8.3.1 Expected and unexpected factors: regulatory

This research has considered how banks process compliance demands; that is, how they interpret or transform demands and make a practical response. Despite a shortage of primary accounts of this phenomenon in the banking sector, theory suggested that bankers, in common with other commercial actors studied, might reinterpret compliance demands in certain predictable ways, such as calculating available trade-offs or soliciting for "control bargains" with enforcers.

Respondents acknowledged that such options existed but not that colleagues would engage in them. In practice, negotiation with the regulator was reported as less common than plain obstruction. Interpreting this phenomenon in Vaughan's (1999) terms: where deviance (in this case coping or creative compliance) has become the norm, regulatees do not see any need to engage in strategies to justify their rule-breaking.

Although theory of enforced self-regulation draws on reasonable arguments, notably the benefits to the regulator of leveraging regulatees' own risk governance, the problematics of banks cast doubt on whether enforced self-regulation may ever work in this sector. Structural tensions inherent in enforced self-regulation are seen to have been tested to an unprecedented extent in the banking sector, where volumes of data are massive; supervised products are abstract, virtual, complex and often opaquely defined; and public reporting officers such as CROs (and by implication auditors) who oversee the commercial side of the control system are rewarded and respected far less than sales-side colleagues. Traders sell, rewarded by potentially large bonus payments and with little regard for cost or the long-term, as they do not intend to stay long. CROs meanwhile receive only salaries to restrain the risk-takers, and may be expected to stay for long enough to have to manage the bank's way through traders' past indiscretions.

Regulators, and indeed banks' own risk staff, appear to have failed to foresee how vigorously commercially-motivated people will reject attempts to – as they see it – prevent them from getting on with their business. (Section 8.4 will consider the implications of this for improving future control of risk in banks, via improved understanding of how behaviour, risk and regulation interact.)

Enforced self-regulation is too weak to challenge an economically dominant sector. "Regulatory capture" meanwhile seems inadequate to describe the depth of banks' contempt for their regulator. Like other organizational managers, bankers may be expected to resist regulatory controls, but banks' resistance is of

a higher order: Not only are accidental gaps of regulatory definition exploited; the legitimacy of the regulator is itself suspect.

Even use of tougher enforcement might not have improved matters in 2008. Problems stemmed not only from banks over-relying on econometric risk models but from supervisors who could not get close to the systemic root of the problem: That traders could take excessive risks, unconcerned by borrowing costs or long-term business sustainability. With a short-term view of both of markets and of their own employment, traders felt invulnerable; longer-term loyal staff in the back office could always be relied upon to clear up any mess.

Whilst self-assured regulatees are predicted to resist controls, and indulge in creative compliance²⁹, something more nuanced is happening in banks. Bankers' responses to compliance demands are not conceived as a binary choice (to comply or not to comply) but as points on a more diffuse "scale of intent to comply". Senior bankers' behaviour is shaped by an extreme variant of regulatory capture: if there is no significant concern about the regulator, it hardly seems worth devising rational strategies to resist; easier just to cope, with the help of a tame risk officer to take everyone through the formalities of audit and reporting.

8.3.2 Expected and unexpected factors: organizational

Theory of organization suggests that banks will experience tensions between formal organizational protocols and informal group responses to external demands. As noted above, banks might also be expected to claim compliance regardless of whether any actual organizational behaviour warrants that claim. The tension that this creates in the organization might be expected to be familiar to a CRO; and this proved to be so. CROs see, and indeed participate in, a fracture between public claims of good governance and private, informal knowledge of compromise. Also as expected, CROs were well-placed to witness

²⁹ as established in sector studies of food production (Yapp and Fairman, 2004), healthcare (Bevan and Hood, 2005; Kodate and Dodds, 2009), pharmaceuticals (McGoey, 2007) and chemical production (Etienne, 2010)

inconsistency between their firms' formal, designated structures and the way that informal groups within them behave.

As with regulatory capture theory above, the literature raised expectations that bankers might resort to performative responses to cope with the regulator's unwanted disruption of normal business. A public show of reporting compliance might be a convincing distraction from the reality that no management systems or behaviours had actually changed; this research expected to find such factors influencing CROs' behaviour. In the event, the present research found banks' behaviour to be shaped partly by performativity, leading for example to the production of plausible (but manipulated) regulatory risk reports. However, other factors had influence:

First, that respondents saw colleagues expressing a strong optimism bias, vesting great confidence (pre-2008) in the potential of derivative products to “engineer away” downside risk. This attitude made traders exceptionally resistant to conventional approaches to risk governance, presenting a particular hazard within a system of self-certifying risk control (such as enforced self-regulation).

Second – and a dominant factor informing the CRO relationship with the Board of an aggressively noncompliant or “bad” bank – bankers seemed to care little about the consequences of noncompliance, based on a notion that banks are “bigger than governments”.

Each of these factors increases public exposure to risk, and fragility in the banking sector. Yet banks' response to public concerns prior to 2008 included creating the CRO role – which may itself be seen as a performative act, designed to display good intentions of better managing risk. As the research affirms, bank Boards regarded their creation of the new senior management role of CRO partly as an appropriate response to regulatory demands for public reporting of risk, but also as a person on whom all responsibility for internal risk controls could be “parked”. In practice, the two functions of public risk reporting and internal control were often found to conflict. For example, competitive pressure drives banks to push products and services into the market as quickly as possible; while

compliance risk management prefers to take more time to size up possible hazards arising from the product.

CROs themselves conceded that the creation of the CRO role was performative; they accept that it can involve performative duties. In the worst cases the CRO role quickly degenerated into a function for supporting profit-making, whilst reframing any duties which conflicted with this. Many banks' optimism bias was such that in effect they ceased to be governed by systemic risk controls; they may even be regarded as ungovernable. Far from managing risk, for many CROs the role consisted of struggling to manage irreconcilable demands.

At the outset of this research it was anticipated that the regulator might reasonably expect CROs, out of self-interest, to support enforced self-regulation. Instead, enforced self-regulation was found in practice to have the unintended effect of placing CROs in a conflicted, even untenable, position. UK bank CROs were expected to represent, and internalise, the regulator's concerns whilst being paid by the employer firm to deflect any risk reporting burden which might detract from profit.

CROs reflected that their function turned out to be less defined and more complex than anticipated or officially prescribed, requiring sense-making in order to decide between various loyalties and priorities. As empirically found, the lines between reporting for the public good and for internal profit were indistinct, masking a more complex relationship between CROs and rules.

Some theorists of organization propose that employees' innate motivation is the determining factor here (as identified in Chapter 6). Certainly respondents recognised that a problem lay in different notions of risk between public sector policymakers and private sector traders; bankers' risk was more commonly conceived as as "focus on commercial outcomes" (C18) than hazard prevention.

This connects with the question of how the CRO may privately reconcile the differing notions of risk within the organization; the following subsection will consider this and related aspects of sense-making.

8.3.4 Expected and unexpected factors: risk perception and sense-making

The final analytical perspective, risk perception, concerns how personal cognition of risk influences decision-making under uncertainty. The literature of risk perception identifies cognitive factors which might have been expected to predict the behaviour of CROs and their organizations. These factors range from the brain's physical management of cognitive process, to behavioural psychology of decision-making under uncertainty, with related considerations such as affect and sense-making. Here one might confidently expect the personal experience of the CRO, as the bank employee explicitly identified with a grasp of risk information, to add to scholarly understanding.

CROs do engage in sense-making, much as Weick (1995) predicts in managers who must make decisions based on unreliable or contradictory information. As identified in Chapter 7, for CROs difficulties begin with the role itself, with its built-in tension between public reporting and commercial profit-making. This tension is exacerbated where the quality of risk data available varies, and where colleagues are willing to filter and manipulate data, with constant pressure to “massage” reports of regulatory capital. Facing all this, a CRO may decide to mount a personal challenge to systemic problems, or more commonly may seek to make sense by looking for ways to adjust definitions of risk and expectations of the role.

Respondents have rationalised sense-making in the course of telling their experiences: even as they understood the limits to their authority, they tried to find an alternative and more palatable way of framing the problem of compromised controls. Sense-making solutions included creating any risk management initiative – no matter how simple – which might be popularly seen to work; and creating risk new report formats which had no practical influence over front-line risk-taking. Sense-making did not (and does not) entail making substantive change; rather, the CRO comes to live as a “coping agent”, supported in this adopted role by the approval of commercial colleagues.

At the individual level, then, uncertainties of fact or allegiance, and/or simple fear for self-preservation lead some risk officers to engage in sense-making. This produces private compromises which allow the individual to justify (at least to themselves) remaining in a role. The dominant version of sense-making which emerges here is the CRO strategy of a rationalised giving-in to commercial interests, on the grounds that this is what the employer expects. Such sense-making by “knowing and not knowing” may be interpreted as either occupying a parallel cognitive state (after Cohen, 2001) – or less charitably as a cynical walking away from one’s responsibilities.

CROs essentially have three strategic options for role definition, two of which may lead on to sense-making. They may challenge strongly on principle, confronting those whom they see to be abusing the risk reporting system; this approach does not admit alternative interpretations. The sense-making alternatives are: First, to try a more subtle approach to effecting change, seeking incremental steps to encourage appropriate behaviour, such as working to teach commercial staff about the wider significance of business risk, but allowing that there will be some renegotiation as to “what really matters”, both with colleagues and to oneself. Second, they may go straight to a sense-making mode of engagement by simply capitulating to the prevailing profit-seeking culture, perceiving this to be an irresistible force. Rationalising such a move to oneself would certainly require some adjustments in personal risk cognition.

At a level below these strategies of sense-making there are many everyday forms of coping activity. These are so varied that they are discussed in a separate subsection below (8.3.6). Remaining at a strategic level meanwhile, the next subsection proposes a method of conceiving “intent to comply”, newly combining present findings with the literature on creative compliance.

8.3.5 Explaining the variety of banks' differing attitudes to compliance: a scalar approach

This section will propose how banks' compliance intentions may now be better identified and characterised.

Although much comment has here concerned findings which imply high levels of noncompliance across the banking sector, this must be moderated by noting that respondents had been encouraged to discuss control failures. It should not be concluded from these discussions that banks are systemically corrupt. It is however appropriate to try to distinguish between the cultures of risk prevailing in banks with a range of distinct commercial attitudes. Respondents hinted at this by using the (informal) terms “good bank” and “bad bank”. Most CROs suggested some version of the notion that good conduct is the aspirational norm (other than on banks' trading floors): “the vast majority of City people are... trying to do a decent and honourable job” (SM1). So: The good bank may be seen as the virtuous ideal, pursuing compliance; whilst the bad bank is caricatured as shamelessly opportunistic and non-compliant. These might be labelled respectively as compliant and defiant, and seen to stand at opposite ends of an ethical scale. Several respondents also suggested the value of recognising a third type of conduct of business, between the extremes of compliance and defiance: the “out-of-depth” or “muddling through” bank; this term is used to describe those institutions, often recently amalgamated, which attempted to trade complex financial instruments without properly comprehending the risks involved.

The continuing instance of major control failures at time of writing³⁰ indicates that banks continue to face serious problems in restraining the conduct of risk-taking salespeople. The pragmatic approach of the past, that occasional lapses are to be expected and that banks should continue trading and only stop when forced to by the regulator, is no longer politically acceptable. Yet the industry has still to find a better systemic answer (see section 8.5).

³⁰ For example: *JP Morgan reveals shock \$2bn trading loss*, BBC News, 11th May 2012; *Barclays fined over rate-fixing*, BBC News 27th June 2012

The market shock of 2007-8 also challenged the practical value of advocating reasonableness, or rational response, in regulation. Pre-2008, warnings that businesses tend to exploit soft regulation had lost ground to arguments that an equitable approach to supervision is better for all concerned. By the time of the 2008 crisis, all actors appeared to have accepted the premise that, provided firms signalled that they were co-operating, the regulator should not rush to intervene aggressively. Consistent with this rationale, a common industry response to the banking crisis is that it has been more a failure of execution than of concept. For CROs, this commonly meant accepting that their employment incentives were too closely linked to reducing costs of compliance – usually meaning, in practice, the largest cost item directly under their control, as noted earlier: regulatory capital. Respondents' experiences suggested a need to revise the regulator's official concept of compliance: The rest of this section addresses that need, proposing to develop one representation of that concept, as first raised in Chapter 3.

Bankers are found to be similar to managers in other sectors, in being willing to conceive compliance as scalar, rather than binary. This suggests that control agencies might themselves usefully re-conceive compliance, moving away from the idea of it as a binary choice (that is, that “you either comply or don't”). Rather, compliance should be regarded as scalar, ranging along a line between “full compliance” and “full defiance”. This in turn implies a large opportunity – beyond the resources of the present study – for regulators to research and redefine what “compliance” means for practical purposes. Meanwhile, the perceptions initially collected here offer a simple interim view, that compliance is negotiable depending on cultural context; and particularly so within an industry which holds its principal regulator in low esteem. These perceptions may help as a starting-point towards developing in future a more precise ‘scale of compliance’ beyond the notional model here suggested.

An early notional scale of compliance proposed by Morgan and Soin (1999) has suggested that the poles of the scale consist of progressive (“good compliance is good business”) and defensive (“pragmatic adjustment”). As here suggested, the

scale can be extended further to recognise extremes of both compliance and defiance, in the forms of super-cautious ‘angels’ and determined deviants, respectively (see Figure 8.1).

This scale of “compliance intentionality” is an initial attempt to capture on the page how CROs might characterise their own varying attitudes to compliance. Three sets of characteristic labels for behaviour represent the three different rationales (or sense-makings) offered by CROs depending upon who is asking for the explanation: the regulator, work colleagues, or their own private sense of what constitutes an ethically correct course of action. The scale ranges from left to right. At either end of the scale lie, as one might expect, the poles of full compliance and full defiance³¹. At the left hand end is the scrupulously ethical practitioner who aspires to, and may come close to achieving, full compliance – although as nearly all respondents noted, some degree of interpretation is always inherent in compliance. At the right hand end, typically insulated by a “bad bank” culture of regulatory game-playing, sits the risk manager who has sold his soul for profit (or less colourfully, capitulated to business interests). A CRO at the right hand end of the scale is interested in helping traders to sell, and is not troubled by the need for reporting transparency.

With recent extreme experience of coping, CROs have proved to be a useful source of conceptual framing to populate this model. Subsequent research – beyond present resources – could further develop this model to increase its explanatory power. Whilst the two ends of the scale are intuitively obvious, it is the coping range between the two extremes that most concerns the present study. As respondents confirm, the role of CRO is inherently interpretative. For example, it can be easier for a novice CRO to excuse misreporting by blaming occasional lapses of process; harder, certainly for an experienced CRO, to ignore or excuse repeated downward revisions of reported risks by means of redefining terms or cherry-picking test results.

³¹ The three horizontal layers represent compliance states as conceived or labelled by (from top to bottom) the regulator, the individual, and colleagues within the informal organization.

Figure 8.1: Coping, within a range of responses to regulation (compliance intentionality)

	Error-intolerant		Tolerating inconsistencies		Misconduct
<i>As characterised to regulator, or by social science</i>	Rigidly moral, ritual conformist	Honest triers, normative	Situationally moral, subverter	Opportunist, rebel	Deviant, withdrawer
<i>As rationalised to self</i>	Error-prone angel	Battling hero	Making the best of it, only human	Ingenious	Creative, determined
<i>Organizational view (culture, signals, actions, phrases used)</i>	Zero-tolerance, "every penny counted"	Ignoring "immaterial" amounts; occasional juggling	Regular juggling between budget lines	"Playing the grey", Re-labelling, strategic ignorance	Fraud, "doesn't apply to me"
"COPING" RANGE?					

(Model: Author's own synthesis from present research interviews, also with acknowledgement to Becker H.; Bevan and Hood; Leidner; Yapp and Fairman; Vaughan; McGoe; Sykes and Matza)

The present empirical findings support the direction of other studies which problematise the binary distinction between 'compliance' vs 'non-compliance' (e.g. Kinnaird, 2005; Fairman and Yapp, 2006). Unprompted, many CROs already conceived organizational compliance with regulatory demands not as a simple binary outcome (compliant or non-compliant) but as continuously varying. An individual's perception of their own compliance may thus lie at a point somewhere along a scale.

Descriptive terms used in the scale were derived by combining and structuring present research responses together with published findings of coping responses in other sector studies: in particular, Bevan and Hood (2005), Yapp and Fairman (2004), Vaughan (1997), and McGoe (2007). The resulting notional scale does not represent a numerical index (although it implies potential for future research to calibrate such an index). The model may, in time, assist wider research in the field by providing a basis for comparing compliance-coping behaviour within and between various regulated sectors.

This also allows for visualising how a "priming" effect occurs when the regulator intervenes. This effect was noted among respondents (and concurs

with the theoretical prediction made by Ayres and Braithwaite [1992], and empirical studies in other regulated sectors³²): Where regulatees perceive clumsiness in the design or enforcement of regulation, they are more likely to feel induced towards non-compliance.

Bankers' compliance intentionality is also influenced by the same organizational factors that Kodate (2009) noted shaping rule-breaking among hospital doctors. Bankers similarly deny deliberate resistance to regulatory controls, claiming here that it non-compliance is more about having "different priorities, you know, 'better things to do than that'" (C22). Some preconditions identified by Kodate are also familiar to bank CROs, such as: powerful informal groups ("club culture"); ambiguously drafted rules, which are creatively reinterpreted; and suppression of critical feedback. Kodate predicts that self-regulating compliance will work in an organization only when there are transparent reporting procedures, integrated with other forms of risk management. By such means, differences of professional understanding are not allowed to become an excuse for ignoring practical lessons (as when reviewing errors).

8.3.6 The nature of coping responses

Substantive compliance requires significant commitment of banks' resources, which few are willing to meet without resistance. It has emerged that banks give disproportionate effort to satisfying the regulator's demands for information at a surface level. Compliance demands may be coped with by means of a narrow focus on correct paperwork – "box-ticking" – which delivers apparent compliance without the trouble of actually assessing risk. Lacking the resources or senior management support to produce full compliance, or a financial incentive to care about macroeconomic goods, a CRO may be tempted to overlook their implied public duty of care – that is, to engage in risk governance for the good of financial markets and of the host nation's economy.

³² for example in the fields of healthcare (Bevan and Hood, 2005), food production (Yapp and Fairman, 2005), pharmaceuticals (McGoey, 2007), public administration (Torriti, 2007) and tax accounting (Picciotto, 2008).

A notable unintended (coping) consequence of self-regulation was for banks' risk offices to succumb to the "Goodhart effect", recalibrating risk according to an artificially narrow measure. The narrow measure most often mentioned was regulatory capital. As an artificially constructed figure designed to satisfy regulatory demands and not coming from the management accounts of the business, it does not explain dynamic trading risks. Such business activities are, of course, recognised in the management accounts where they inform the Board's view of business risk (including the true, economic capital, valuation). Yet much of the CRO's time is occupied with producing a favourable – that is, as low as possible – regulatory capital figure. This is institutionalised coping, having no net benefit to risk management; in fact, by simply releasing additional funds for traders to take risks with, this activity may be seen as increasing the bank's fragility.

Coping is conceived by CROs in several ways: First, as a normative or expected as an amoral calculation (after Pearce and Toombs, 1990). Second, as sense-making (Weick, 1993) – that is, privately interpreting how the market really works. Finally, as preparation to exercise collective deniability in the event of a transgression (McGoey, 2007). An alternative conception of coping might have been for compliance activity in general to be seen as taking place in some form of separate cognitive compartment from the core business function of making money. This notion of cognitive disengagement is variously referred to as a "parallel universe" (Gapper and Denton, 1996), "other state of mind" (Cohen, 2001), or "fantasy" of control (Clarke, 1999). However, this explanation was not offered by, or apparent among, respondents.

One other theoretical justification for coping is also not found: Cohen (2001) notes that powerful leaders may detach themselves cognitively from their own published reporting documents, dismissing as "insignificant" mere "marks made on paper". If so, consistent with established models of deviant rationality (Vaughan, 1999; Sykes and Matza, 1957) one might also have expected respondents to explain away bad behaviour with known rationales such as

creative freedom³³, for example, or economic need³⁴. In practice, they did not: Instead, rather than seeing any need to rationalise noncompliance, a more common characterisation of this behaviour was a self-assured certainty that a robust response to a regulator is “just the way we do things around here” (Spitzer, 2009).

While as corporate organizations banks have many features in common with other corporates – and so susceptibilities to rule-gaming by informal groups – it is clear that in many significant respects the culture and activities of banking set financial businesses in a class apart. The extreme nature of bank CROs’ coping is not fully explained by the literature. Coping activities apparently unique to bank CROs include manipulation of financial risk input data; creative reduction of reported regulatory capital; and support for econometric risk models based on the ability of these to offer apparent regulatory compliance for a new product, rather than actual customer protection. Also at the extreme end of coping strategies are the Board’s creation of the CRO role as “flak catcher”; and the private sense-making of a CRO who chooses to survive in office by capitulating to commercial interests.

If survival strategies are the negative or defensive aspect of coping, CROs do also recount more positive framing of coping as career management. A necessary precondition for survival in office is to recognise, and accept, the cultural divide between traders and risk managers. This is so axiomatic that it is often mentioned as a self-deprecating “aside” comment, such as that salespeople “do find compliance (activity and people) broadly irritating” (C16).

This paragraph identifies briefly a range of personal (coping) responses enacted by CROs to process conflicts in their deployment of risk information. A CRO might disown their presence in the process, overlooking a known risk in a “Nelson’s eye” game. They might support traders’ assertions that everything was all right, on the basis of “the way we do things around here”, or that a

³³ That is, that a commercially creative organization ought to resist any external intervention which threatens this creativity; a (false) rationale Cohen calls the “morally appropriate” argument

³⁴ That it is the duty of a commercial organization to restrain all sources of cost, including compliance costs

contention often repeated takes on the appearance of a truth. To prevent being marginalised themselves, they might sideline other staff who dissented from an approval of a risk. As discussed at length above, they might engage in creative reporting including “work-arounds” to produce a suitably upbeat report on a corporate commitment such as regulatory capital. They might succumb to instrumental conditioning, agreeing fatalistically with others that compliance is insignificant because either prosecution is unlikely, or it would be troublesome to force others to do something non-profitmaking. Finally, they might themselves seek reassurance in the knowledge that the “revolving door” will soon take them out of the difficult situation; the point being to survive through a three-year term of appointment without any embarrassing control lapses occurring on one’s watch.

To conclude on coping: The finding that CROs engage in coping leads back to the original contention of this research: that some regulatees might be found to have flexible notions of compliance. With sufficient numbers of individuals, sufficiently engaged in similar coping strategies, creative compliance might begin to operate at the level of the organization. Coping was found to be a systemic tendency in those banks which would “shift towards playing the system if the regulator seems to be intervening too much” (C27). It may be inferred that well-intended financial risk control initiatives may be expected to fail when traders are allowed to dismiss them as “interruptions to business” (C10), or when Boards rationalise that “the more the intervention, the more [we should] shut down engagement with the regulator” (C27).

Whilst the existence and nature of coping among CROs is a distinctive finding of this research, it is only one aspect informing wider conclusions which are now presented.

8.4 Conclusions

8.4.1 Addressing the problems found

Primary research substantially confirmed an expectation from the literature that risk office good intentions will crumble when placed within a skewed system. The bank CRO faced a system loaded against their public reporting responsibility, where risk-taking was more incentivised than risk management and where the interests of informal sales-side groups had long dictated behavioural norms. Traders were able to reframe aggressive risk-taking in forms which were more locally palatable – diluted by favourable econometric models, materiality thresholds in aggregate balance sheets, and a pervasive culture that risk containment was strictly the preserve of the back office.

The first conclusion is therefore pessimistic: Enforced self-regulation is an unsuitable control system for banks, because they are not internally governable. Rather, banks are governed through financial market forces and in practice judge their own ultimate success narrowly by how much money they can make. When it comes to business decision-making, power within a bank does not flow from respect accorded to formal job titles; rather, it is culturally awarded to the most forceful managers, often meaning the most forceful personalities and those who achieve the highest gross sales.

Regarding banks' external contacts with regulatory agencies, far from seeking to contain the regulator by negotiating control bargains or trade-offs, sales-side bankers seem to be untroubled by the regulator's presence. Reassured by their own institutions' collective economic dominance, they feel free to behave like the proverbial "bad boy" at a fee-paying school, who knows that his rich parents will bail him out of any trouble. To force this analogy a little further, bankers' contempt for regulators, as outsiders, is akin to the abusive saying "those who can't, teach".

There are significant concerns about how far any agents of public risk control are simply ignored. Analogous research in other regulated sectors suggested that self-assured managers may regard defiance as a normal option when responding to the regulator; it did not sufficiently predict the high level of indifference found in the banking sector. This level of abuse – or disengagement – suggests the need for a fundamental rethink of regulatory approach to the deployment of case officers, for example requiring them to make more direct observation of behaviour on the sales side of the business.

CROs' experiences challenge a regulatory assumption that rational decision-making is normal in working life. For the regulator to expect the CRO, as a single officer of the business, to stand against all the asymmetries ranged against them is wishful. It may also be disingenuous, if the CRO role is known to be in practice a coping agent – or more colloquially as a “fig leaf” for probity in risk management. As the plainest example of affective factors at work, a CRO's decision whether to report an anomaly may be influenced by a dread of personal consequence (such as being labelled a whistleblower, prospective loss of job, and then perhaps to be unemployable as a known troublemaker).

8.4.2 Implications of the research for improving CRO effectiveness

Without an upgrading of role, scope, status and reward, the office of CRO runs the risk of failing to fulfil any real function, let alone meeting all the expectations placed upon it by public opinion and regulators. Conclusions are now offered as to the efficacy of the CRO.

By their own admission, many CROs were indeed installed as a coping (deflection) strategy by banks' Directors, making sense of compliance demands by deploying responses that “looked right”. This was not necessarily with any devious intent but was under an overriding imperative to continue marketing products. CROs' practical value was less in arguing against any specific regulation than in preventing adverse effects – especially regulatory costs – to the business. Risk management too often is organizationally placed as an early

shaper of decisions; it is irrelevantly positioned as the last stage in a decision-making process, or even a “box-tick” after a decision has been taken.

As to having (or attempting to create) any influence (C18’s “real power”), few CROs initially recognise how the organization has limited their authority, with most discovering only over time that they lacked influence in office. Nevertheless there is recent optimism for a stronger future role, with risk governance and Financial Conduct draft principles now emerging from a general regulatory review. Statutory strengthening of the role of the CRO, and of Non-Executive Directors, will be welcome to protect them when challenging Board decisions. Any new powers prescribed by statute will still have to be proven to work in practice: for now, CROs lacking Board support will still have to canvass for allies if they want to achieve substantive progress in risk governance.

Risk officers must also look beyond econometric risk modelling to solve problems of control. Past over-reliance on quantised risk-modelling tended to misdirect risk supervision on several levels: at a high level, by falsely conflating multiple processes, whilst at a transaction level, ignoring macroeconomic trends. Models failed to generate either a “big picture” warning of crisis or a useable temporal prediction of imminent change in market sentiment.

On a related point of reforming culture, the next generation of risk controls needs to direct supervisors’ attention more closely to the behavioural origins of non-compliance, rather than relying on econometrics. Future efforts might usefully be directed towards observation and analysis of elements which create distortions in risk control; these elements are behavioural rather than financial. They include aggressive risk-taking conduct; coercion to manipulate reports; and denial of opportunities to question decision processes. New controls should also identify as significant the types of misconduct which CROs have highlighted here, such as: senior traders who treat bank resources as their personal fiefdom; a self-replicating culture of hiring aggressors and firing anyone who dissents; and short-termist initiatives which extract immediate cash from the business at the expense of long-term protection of value.

Similarly, notions of regulatory capture should be revised to accommodate banks' extreme practice of it. The position of CRO may have been created as a proxy for the conscience of the organization, but for some CROs this meant becoming part of an organization entirely conditioned to exploiting advantage over the regulator. "Capture" is an inadequate term to describe what was occurring, or the behaviour underlying it. The theory of capture entailing "payoffs" is rendered irrelevant where bankers see cooperation as unnecessary and where an inconvenient national regulator may be aggressively challenged by relocating into a new jurisdiction (*regulatory arbitrage*). Banks' option to relocate or "jurisdiction-hop" presents an unusually strong challenge, which is not, of course, a strategy available to many other regulated businesses, such as utility providers, which must remain physically attached their customers in a defined geographical area.

Earlier models of partial compliance showed practitioners engaging in reframing risk definitions to fit extant regulation; an ex-post activity. Banks, by contrast, have been seen to be able to exert strong leverage over the regulator on an ex-ante basis, since the regulator's own understanding has relied heavily upon practitioners' explanations of what is happening – adding cognitive capture to the exploitative factors. This is firstly a result of selling of complex and opaque products which were often created to arbitrage tax or regulatory capital regimes, and secondly, with a lack of respect or reward for the function of risk management. These two issues have had a direct impact upon the authority and effectiveness of the CRO. The first (opacity) problem could be solved by mandating far greater transparency in reporting, backed by fully independent audit. The second (respect and reward) problem is a cultural issue which needs to be addressed systemically by compelling bankers into greater engagement with risk management; a market-based solution for this would of course be preferable to a regulatory enforcement.

Lack of popular mobilisation against financial wrongdoers has also allowed for significant control failures. The banking sector's defensive reliance on old assumptions about the inherent value of its work now require more vigorous public challenge. Since deregulation in the 1980s, banks have moved far beyond

their original function of deposit-taking and lending, and notably into speculative trading on their own account. Outside times of financial crisis, public attention drifts away from corporate wrongdoers, focusing more naturally on violent street crime, and there is greater apathy about regulatory agencies' rate of prosecuting corporate offenders. Whilst the 2008 crisis has naturally sharpened public focus in the short term, over the long term a lack of sustained and mobilised public concern threatens to allow banks to revert to "business as usual", with diffuse accountability for traders' risk-taking.

CROs do not emerge well from this aspect of the debate. Before the 2008 crisis broke, respondents broadly perceived that all parties concerned with regulating, or being regulated, should try to refrain from publicly criticising the FSA's light-touch approach to supervision, as long as the market remained buoyant. This form of sense-making (or even denial) strategy, sometimes known as a "game of no game" (Cohen, 2001), fails to confront the lessons of major market shocks, of the type experienced from 2008 onwards. To disengage from active risk management on the basis that the regulator "knows best" is disingenuous, if not dishonest as a rationale for avoiding public responsibility.

Connecting all of these aspects of developing efficacy is the question of how to give risk control real authority. If the role of CRO is to have the true authority to influence and change bankers' behaviour, this will require not only statutory authority but also a mandate directly to observe behaviour and prosecute misconduct. Without these powers, the CRO role may come to be – or continue to be – regarded as an interesting but ephemeral experiment in establishing the practical limits of authority and self-reporting of risk. If popular opinion concludes that this experiment is failing, an alternative approach might be to abolish the CRO role and replace it with a new, statutorily backed, independent risk auditor. The scoping of such a role might be the most useful starting-point for further academic study, which is now considered.

8.5 Increasing scholarly understanding: future research directions

Amid all the media noise about the 2008 financial crisis, popular culture has offered several fictional dramatised accounts of the “crash”. It bears noting alongside the various accounts of the crisis in fictional form, that the research here offered is distinctive for presenting the real words of senior people in banks, whose success and future tenure was being judged every day.

As bankers do indeed conceive compliance as scalar rather than binary, the resulting ‘scale of compliance intent’ is a relevant starting-point when defining the problems of controlling bankers’ risk-taking. It does, though, require further development and calibration to be of practical use for the regulator. If the scalar model can now be refined, taking forward present findings, this may come to offer a more nuanced understanding of coping as a game of compliance knowingly played by a highly sophisticated group of risk takers and risk managers.

With some econometric tools discredited, or at least conceptually challenged, future research efforts should address the development of alternative controls based on observed behaviours. The present research has provided some further understanding of how the risk function in banks is modulated in response to pressure from informal groups. Social pressure has here been seen to have as great an impact as technical and financial factors; the influence of informal groups is a feature of the landscape for banks and so should feature on the regulator’s radar. On this same track, further research could usefully challenge the “rationality assumption” that leads policymakers to ignore intuitive and affective factors that shape behaviour in regulated groups. It is, in short, irrational to regulate financial markets as if they are rational. Just as traders are used to making deals based on an intuitive thought process, so too regulators need to learn to observe and engage with this mode of activity: research should look to develop regulatory efficacy by continuing to improve scholarly understanding of the origins of deviant behaviour in commercial settings.

On a related topic, there is potential public policy value in investigating ways to get bankers better to internalise an understanding of long-term risk factors. Banks have been seen to be insufficiently engaged with a collective responsibility of making global financial markets more robust, rather than more fragile. This might be addressed by studying the systemic benefits of fully transparent risk reporting between traders, verified by independent audit. In any event, the present research suggests that any further reform of sector regulation might best be guided by a knowledge of the practical experiences of senior risk managers rather than dogmatic pursuit of a purely systems-based approach.

It is hard to have any optimism that banks will better anticipate and so avoid further crises in future. The history of banks' engagement with regulation to date suggests that, following a flurry of reframing of controls in the aftermath of each crisis, they will then revert to type, meaning pursuit of profit above all other considerations. We may then expect banks to continue to give public support to regulatory initiatives whilst privately devising ways to best limit the impact of these. This long-running story of "beyond capture" is not a simple matter of outright defiance or even of selective interpretation (cognitive capture and reframing). It represents a more complex new presentation of knowledge of risk not as science but as a synthesis of models and practices, with considerable scope for negotiating agreement as to whether a given approach to framing risk is robust or even relevant at all.

At least certain known vulnerabilities of organizations are here reaffirmed: Banks do resemble other regulated sectors when they devise rationales for avoiding compliance costs and look for peer validation of creative compliance. The informal organization may be seen as a form of collective risk-aware agency, within which individuals are constantly reassessing their own position on a scale of compliance. These positions range across collective denial ('groupthink'), to private sense-making, to rejection of control responsibility following a contested claim to loyalty.

Facing day-to-day challenges to their mandate to control risk, a risk officer cannot be expected to function effectively. It is also systemically unsustainable

to force a CRO to resolve designed-in conflicts of demand by means of private sense-making. Future research might address the deficit of understanding with a detailed study of what may be termed the “super-capture” phenomenon, to produce a new taxonomy, since “capture” seems insufficient to explain what banks do to regulators. Better practical understanding of capture could help to avert future failures of regulatory control.

At the same time as developing a new taxonomy of capture, research might also usefully examine the related topic of whether banking merits continued treatment as a special case for regulation. Banking is, of course, a commercial activity fundamentally unlike other regulated activities, combining massive transactions, abstract products, corporate portability, and direct impact on the global economy. However, this should not mean that banks should have a licence to set their own rules of acceptable conduct. Recent market shocks have generated large volumes of commentary on the failings of financial and regulatory analysis and of process management. What has been missing, and future research must pursue, is a new effort to factor in the significance of behaviour. With better understanding of behavioural outcomes – of “what actually happens” – the regulator may begin to achieve greater control over bankers’ tendencies to excessive risk-taking.

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ANNEX 1: QUESTION PROTOCOLS

- Is regulation (which affects you) aiming for tenable goals? Are its targets effective? Is it seen as relevant, as “making sense” in the context of your work?
- Do the regulator’s interventions invite less-than-wholehearted support in response?

- (Could one describe it as a game?)

..and if so:

- Who are the active players? What are the rules?
- What is the aim? What rationales do participants (regulated, and possibly regulators) offer for gaming? (e.g. simple deception? To avoid having to modify behaviour?)

Does the regime inadvertently encourage a shift from “honest trying” to “opportunistic” response to compliance³⁵? Might the regulator be complicit in the game? How?

- What risk communications / artifacts are involved? (formal/informal: e.g. pro-forma compliance reports; minuted meetings; unminuted discussions)

Delphi approach:

- Other respondents have said that..... . Would you agree with that analogy / observation / the point of that anecdote?

PROMPTS TO STIMULATE RECOUNTED EXPERIENCES

“I’m interested to know about your personal reaction to regulation and how you reconcile any differences between your views and the requirements of this organization. Could we start by your telling me about a time when you or someone you know found compliance demands frustrating?”

(If compliance-side):

“Would it be fair to say that there is a difference in outlook between compliance people and marketing people in a financial service organization? Can you tell me about a time when you, or a compliance person you know, came into conflict with people from outside the compliance team?”

(If management / marketing / product-side):

“Would it be fair to say that there is a difference in outlook between compliance people and other managers in a financial service organization? Can you tell me about a time when you, or someone you know, came into conflict with internal or external compliance people?”

³⁵ From Bevan and Hood’s (2005) categories

FURTHER PROBE LINES – for use if time allows

“Are there differences of outlook between compliance managers and product managers? What are these?

Is there a gap between the performance you report and what actually happens?

Can a compliance report ever capture real performance?

What are the hot topics in regulation in this sector right now?

Are there any recent regulatory interventions which stand out? [Which, why?]

What would you ask the FSA, if you could ask them anything anonymously?)

SCALING OF PERCEPTIONS – potential ‘scoring’ exercise

“I’d be interested in what you think of some propositions” [pass one at a time]:

“To what extent (scale 1 – 5) would you agree with it, privately?”

“To what extent (scale 1 – 5) would you agree publicly as a representative of your employer organization?”

“Could you tell me about an example of when this was true for you / your organization?”

1. *Efforts to regulate are motivated by political embarrassment – seeking either to avoid it or recover from it.*
2. *Lower-level managers process work by modifying their roles, reducing the gap between available resources and system objectives. Coping strategies are essential if policy is to work at street level.³⁶*
3. *Regulation by target-setting assumes that targets change people’s behaviour; that reported indicators represent the whole picture; and that ‘gaming’ can be prevented.³⁷*
4. *Regulating is a “Nelson’s eye” game played by government; those at the centre would rather not look for evidence of gaming or measurement problems, as these might call reported performance successes into question.⁴²*

³⁶ Adapted from Kernick (2004)

³⁷ Adapted from Bevan and Hood (2005)

ANNEX 2: ETHICAL DISCLOSURE TO RESPONDENTS: INTRODUCTORY LETTER AND PROJECT SUMMARY

Dear

Re: Risk Management research

The King's College London runs various projects looking at the efficacy of risk management principles as applied to the design of regulation. As part of a study of effective risk regulation in financial services, I would welcome your views as an experienced practitioner.

The study is exploring perceptions of risk and control across the sector. As part of this, to help gain a better understanding of concerns across various institutions, I would like to arrange an interview with you. This would last no more than 45 minutes and would if possible be recorded. I will be asking general questions about the perceived relevance of regulatory controls on risk, your organization's response, and any current focuses of concern.

I would be grateful if you could let me have a few possible dates inso that we can arrange an interview. Please do not hesitate to contact me if you would like any additional information.

Yours sincerely

Roger Miles
King's Centre for Risk Management
King's College London

PROJECT SUMMARY

Staffing: Roger Miles, supervised by Dr Brooke Rogers.

Duration: Project runs from 2006 - 10; original research during 2007 – 09.

Intended outcomes:

- Insight into potential for better regulation in UK commercial markets (consonant with KCRM's continuing work in risk-related policy in Whitehall and Brussels).
- A research dissertation; conference briefings; potentially, published papers.
- Summary findings sent to participants; personal debriefing also available.

Aim: To offer a fresh approach to understanding:

- how UK financial service providers accommodate the need for regulation, comparing regulatory intent with what actually happens;
- how providers interact with regulators; and
- differences between compliance reports and enacted practices.

ABOUT US

The King's Centre for Risk Management is a centre of excellence in research and consulting on risk, regulation and policy issues. Its staff and graduates work in government, industry and NGOs, researching and advising on policy, assessment, management, regulatory design, governance, and communication in relation to risk.

ANNEX 3: GLOSSARY OF ACRONYMS, FINANCE AND THEORY TERMS

ABI		Association of British Insurers (UK sector association for the insurance industry).
(advanced) engineering	financial	The devising, by bank-employed mathematicians, of financial products reliant on statistical probability models. Flaws in risk assumptions on which these products relied were exposed when the 2008 financial crisis hit (for example, that property prices will not fall). Associated products include: precipice bonds; credit derivatives (including the resale of “sub-prime” debt); interest rate hedges; hedge funds; split-capital trusts; and index futures.
Affective responses		Responses based on subjective perception and emotion rather than generated by any rational-analytic process (see Slovic and Lichtenstein XX)
Arbitrage trading		Exploiting (trading on) price differences between different forms of the same asset. For example: <ul style="list-style-type: none"> - the difference in price quoted for the same asset (e.g. a company’s shares) in two different national markets; or - the difference between a share (direct investment) and a derivative (secondary investment) for the same asset. See index arbitrage
BBA		British Bankers’ Association (UK financial sector interest group representing all licensed deposit-taking businesses, ranging from high street “clearing” banks to global investment banks). Produces banks’ self-regulatory codes of conduct and a range of market-enabling instruments such as the LIBOR base-rate index and various Master Agreements.
Bond		A note of a debt, issued by a borrower to a lender. The borrower will typically pay the lender a fixed regular sum of interest over a set period until an agreed date when the bond is to be repaid (redeemed).
Capital adequacy, capital adequacy standard / ratio		As defined by regulation (e.g. the Basel II Accords): The fraction of a bank’s overall business value which the bank must hold ready on its own account (in liquid form) in order to be able to pay off its immediate market obligations. See also regulatory and economic capital. The standard takes the form of a prescribed limit on the ratio of a bank’s own business value (capital) against the value of its contracts currently in the markets.
Compliance		Compliance can be understood as behaviour conforming to the expectations communicated by regulators to regulated actors; the regulatee’s choice of one of the acceptable options available for the performance of a particular task (Etienne).
Contagion / contagion	financial	The tendency of one market or nation to respond adversely to neighbouring events. Contagion is said to be occurring when anxious traders in one nation’s financial markets adjust their

prices pre-emptively as a (psychological) response to events in another nation's markets, where there is no rational (e.g. contracted) reason to do so. This leads to distortion in market prices, sometimes harming economies in other regions even when these regions' own local circumstances are different. "Boom and panic in one country seem to induce boom and panic in others, often through purely psychological channels" (Kindleberger, 1978, p.119).

The term is most commonly applied to market panics ("catching a cold") but other affective modes of behaviour are also recognised to produce distortions: "animal spirits" (Shiller), "irrational exuberance" (Greenspan), "euphoria" (Adam Smith) or "overtrading" (Minsky). The exuberance of the much of the 1990s/early 2000s was a form of contagion originating in debt-propelled US markets.

The term appears to have been first applied during the Asian market crisis of 1997, when a credit crunch among Japanese banks triggered business failures across the region. From summer 2008 commentators have used the term to anticipate transmission of damage from America's sub-prime mortgage crisis into other countries' markets. As noted by Mackay and Kindleberger, borne out by many historic market "bubbles", once mass-market investors' behaviour begins to reflect a perceived (though not yet real) risk, speculative trading turns a crash into a self-fulfilling prophecy.

control model	A model designed to test, monitor and control banking risk
co-optation (see also regulatory capture)	Part of a process of regulatory capture. A regulated interest (or industry) may exert sufficient political and/or economic power to dictate the regulatory agenda. Powerful interests may co-opt (seek to make "control bargains" with) regulatory agents as a prelude to marginalising them. (Ayres and Braithwaite, 1995)
coping; coping responses (to e.g. regulatory compliance demands / enforcement interventions)	<p>A response to situations characterized by uncertainty (Latack 1986); may take the form of deflecting the problem itself (problem-focussed coping) or the personal anxiety that problem effects causes (emotion-focused coping) (O'Neill and Zeichner 1985). Coping responses relevant to the present study include informal modes of compliance; that is, interpreting newly-imposed rules in ways which favour practitioners' continuation of existing behaviours.</p> <p>The term "coping" is deterministically adopted in the present study to include, but not specifically to infer, a spectrum of possible behavioural responses to intervention, including wilful ignorance, negotiative gaming or subversive gaming.</p>
Creative compliance	Manipulation of the law [or regulation] to turn it, no matter what the intentions of legislators or enforcers, to the surface of the regulated actor's own interests and so to avoid unwanted control (McBarnet and Whelan, 1991, P848)
Decision theory	The academic modelling of how humans exercise judgement under uncertain conditions; factors include the neurology and psychology of risk cognition.

Defiance		In regulatory theory, the opposite of compliance: Refusal by a regulated practitioner (or group) to change behaviour in response to the regulator's demands. Sometimes disguised by completion of a regulatory report (e.g. filling in a form) rather than of the task reported on.
Econometrics, econometric Analysis		Highly formalised tools, derived from mathematical modelling of probability, used to calculate risk in financial products. Tools have included Value-At-Risk modeling, Monte Carlo testing/simulation, and stress testing.
Economic capital		See regulatory capital
emotion-focused coping		Coping which seeks to reduce stressful emotions (O'Neill and Zeichner 1985)
enforced regulation	self-	Supervisor-controlled regulation, in which the bodies under regulation are themselves expected to produce the data reports the regulator requires to maintain control
enforcement interventions		Action taken by the regulator's staff against a regulated actor or group, often publicised, to ensure that the regulate conforms to expected behaviour
FSA		The Financial Services Authority; principal regulator for the conduct of financial services business in the UK. (The evolution and present role of the FSA is set out in Chapter 2 of the dissertation.)
Gaming (compliance)		Practitioners' exploitation of the "indeterminacy of rules" (Braithwaite, 2002) to (re)interpret them in a way that strongly favours the practitioner's needs, such as freedom to market a new product.
Hedge fund		<p>Although widely and loosely used, this term tends to describe a fund management vehicle which will typically have the characteristics of:</p> <ul style="list-style-type: none"> - being active in multiple jurisdictions (but not necessarily regulated in any of them); - having a high risk appetite, and therefore not being available to "retail"-level investors; - trading on opportunities for arbitrage; and - highly leveraged (see below). <p>A typical hedge fund might play the "long/short equity strategy" of buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value. Their leveraging (not holding the whole value of the main investment, but borrowing against this value in order to exploit value at the margins) commonly means that hedge fund activity carries a high risk of contagion (hedge-fund shocks tend to generate anxiety among traders in other markets, depressing market prices more widely).</p>
Index arbitrage, arbitrage trading		An investment strategy: Exploiting price discrepancies between an asset and a derivative (an index future) on the same asset. Trading example: Selling a stock futures index which "looks overpriced", whilst buying the underlying stock.

Insider trades / insider trading	The “market abuse” of passing on privileged price-sensitive information, for gain, before its publication in the markets. Lack of success in prosecutions for the specific offence of insider dealing (only 11 individuals convicted in the FSA’s first ten years, 1997 – 2006) has led to a more recent increase in prosecutions under the UK’s Financial Services and Markets Act 2000 (s 397); the new Act granted a wider reach for prosecutors by generically banning any “statement, promise or forecast that is designed to induce someone else to buy or sell shares if the person making the statement either knows it to be misleading, false or deceptive in a material particular or is reckless as to whether it may be”.
instrumental conditioning	The human tendency to acquire from empirical experience the belief that bad behaviour does not have consequences. For the purposes of the present study, the growing belief that control systems may be safely ignored if enforcement action never follows non-compliance (Gonzales and Sawicka, 2003)
Liquid assets, liquidity	A liquid asset is something of value which a business holds and which can be traded immediately. Liquidity is the measure of how quickly and cheaply an asset or contract can be converted into cash. Cash, as the most freely exchangeable asset, has the greatest liquidity. A bank may have many, apparently valuable, assets in the form of paper contracts (e.g. mortgages) but if it cannot market these in exchange for cash it will be unable to trade for long – as Northern Rock discovered.
Liquidity risk	The likelihood of not being able to get hold of the cash required to settle a contract. The operational factor that destroyed Northern Rock, after its cash supply in the credit market dried up suddenly and completely in August 2007.
local interpretations	(Usually) honest attempts to apply broadly-drawn rules to the narrow context of an individual or group’s own business unit
Market shock	An event that disrupts normal functioning of markets, typically by undermining assumptions which the market had relied upon, and typically triggering a collapse in asset prices. Examples: Earthquakes (Kobe, 1993; Tokyo, 2011); interbank credit freeze (2008); regulator’s suspension of a major institution (Lehman, 2008); big-ticket rogue traders (Leeson, Kerviel).
Minimal compliance	Relegating of the activities of the compliance officer or supervisor to secondary status, for example by excluding them from areas such as trading rooms where full compliance is expected by the regulator.
Mis-selling	As the FSA’s own definition (FSA/PN/052/2003) remarks, “arguably, mis-selling is not a regulatory concept at all” but merely a popular term for “unsuitable or detrimental” product sales by a financial adviser to a consumer. This is further defined as selling which contradicts the practitioner’s general FSA-prescribed obligations to act with integrity, care and diligence, to communicate clearly and treat customers fairly. The FSA has notably intervened on behalf of customers “mis-

sold” certain pensions and mortgage schemes.

Monte Carlo analysis	A highly formalised tool for risk calculation, used in econometric analysis; essentially, a simulation of “spinning the roulette wheel” (launching trading) of a financial product to see how it will perform. On the face of it, a fair way to assess risk; in practice, wide open to manipulative reporting (for example multiple running of simulations, followed by selective reporting of only the most favourable test results).
Moral hazard	Market risk which arises after an external agency (e.g. a central bank or regulator) has intervened to support a practitioner organization which had taken on imprudent risks in the market. Such intervention undermines the regulator’s claims to be “maintaining orderly markets”, as it may appear to encourage other practitioners to take on greater risks (since the regulator may now be expected to rescue any failing practitioner). Such an intervention also forces the regulator to defend the awkward premise that a practitioner may be given preferential treatment after a failure of regulatory oversight. (See Annex 4, Northern Rock case notes: The Bank of England’s funding for Northern Rock after its business model failed).
Negotiable space	Belief that regulation is open to interpretations which favour the practitioner. In this view, coping is seen not as subversive but as realistic or pragmatic: as one CRO has put it, creation of “negotiable space” is in the interests of regulator and regulated.
Newtonian assumption	The rationalist premise that regulated actors “know what’s good for them” and so may be expected to self-correct deviant behaviour as soon as new regulations are introduced
normalization of deviance	of Phrase used by Vaughan (1996) to describe institutions’ excusing of rule-breaking as “just the way we do things around here”, or even encouragement of “gaming” of control systems (see also Bevan and Hood, 2005).
Northern Rock	British mortgage bank which suffered a catastrophic loss of depositor confidence (a “run”) following failure of its funding model to generate sufficient cash from short-term money trades (qv) to fund its customer obligations during summer 2007. (See case notes, Annex 4).
Offshoring	contracting for risks across or beyond national boundaries, to escape the jurisdiction of nation-state regulators; a perverse consequence of tightening regulation in any one jurisdiction is that it may weaken control because practitioners will offshore any affected products
Operational risk	A catch-all term used to describe any risks not directly ascribed to credit or market factors. Operational risk is the potential cost arising, directly or indirectly, from inadequate or failed internal controls or from external events. Such risks might include regulatory intervention, incompetence, fraud, inappropriate risk modelling (see Annex 4 case entries on LTCM and Northern Rock), and systems failures.

Performative response		In plain terms, going through the motions of complying (or creating the appearance of compliance), but not actually changing underlying behaviour
problem-focussed coping		Coping which regulates stressful person-environment interactions (O'Neill and Zeichner 1985)
Prospect theory		Proposes that a rational actor makes a decision based on its "expected outcome value". This value is a product of subjective probability multiplied by a psychological weighting (empirically identified by Tversky and Kahneman, 1992) which reflects the human tendency to overestimate low probabilities and underestimate high ones.
Prudential policy (regulatory)		A policy (and in practice, standard) set by the regulator for appropriate risk-taking. Many of the FSA's current control specifications are set out in a manual entitled The Prudential Sourcebook.
pyramid enforcement	of	Principal that the greater the risk taken, the tougher the enforcement action that a regulatory agency may choose to take against its perpetrator in the event of wrongdoing. (Ayres and Braithwaite, 1992)
Rational compliance	non-	<p>"Whenever a standard is set, some firms will decide that the costs of compliance are greater than the costs of noncompliance (probability of detection multiplied by the costs if detected). As standards are made more stringent, the costs of compliance increase steeply while the costs of noncompliance remain more or less constant. Hence, as standards become more stringent, the performance of firms that comply improves, but additional firms choose to risk penalties for noncompliance... thus... further tightening of a standard may lower overall performance."</p> <p>(Ayres and Braithwaite, 1992, p107, based on Viscusi and Zeckhauser's 1979 research findings)</p>
Regulatory arbitrage		Also known as "jurisdiction-hopping": the practice of relocating one's corporate headquarters (and hence regulated reporting) into a jurisdiction which offers the lightest compliance burden (or disclosure requirements).
Regulatory capital and economic capital		Regulatory capital is a monetary amount (or percentage of business value), prescribed by the regulator, which a bank must hold ready to pay its immediate market obligations. Economic capital is a more commercially discretionary amount which a business may choose to keep available to fund its own continuing market development.
regulatory capture		When a politically and/or economically powerful regulated group is able to use this power to dictate the regulatory agenda
Regulatory risk		The commercial cost, or probable cost, engendered by compliance or otherwise with regulation; the commercial impact of compliance with regulation itself
Regulatory theory		essentially concerns how rules may framed so as to influence behaviour and secure support for the rules (compliance).

Response effects	Ways in which researched respondents adapt their behaviour or responses because they are aware of the researcher's presence (e.g. answering with "what the questioner wanted to hear", as distinct from what the respondent actually perceives or believes). May call into question research validity where responses are other than might be expected. Noted as a factor possibly compromising findings in the Hawthorne studies (Mayo, 1949).
Risk	A broadly applied and defined term, occurring as a key concept, albeit with various professional inflexions, in literatures of public health and safety, clinical medicine, financial product engineering, civil engineering, insurance underwriting and actuarial work – none of which is the focus of the present study
Risk communication	The way that risk is communicated between stakeholders, particularly between CRO and other internal members of the organization and between CRO and regulatory supervisor
risk control stories	
Risk metrics	Methods of formal measurement of risk; see also econometrics
Risk Reports	In banking, conventionally accepted in the form of summary trading activity stress tests
Run (as in: run on a bank; bank run)	To maintain a business, banks rely on their depositors leaving money on account; money deposited is lent on to borrowers, generating interest payments. If depositors lose confidence that the bank is a safe place to leave their money, and demand their deposit back, the bank may not be able to produce the cash necessary to repay them (because the money deposited may be "out at work"). When depositors become anxious and decide to withdraw their funds en masse, the cash shortfall becomes self-fulfilling: A sudden mass demand for cash can render a bank insolvent, although ironically it is this "run" which will have created exactly the outcome which the depositors feared.
scale of compliance model	A model of compliant behaviour designed to question the validity of the binary indicator (which suggests that regulated practitioners are either compliant or non-compliant). This model proposes degrees of "compliance intentionality" which may vary according to external circumstances and individual affect.
Securitization	Converting the value of assets held (corporate equipment, property, mortgages) into paper contracts which can be traded on the financial markets, as shares are. For example, a mortgage bank's "securitized debt" could be the consolidated total value of its mortgage loans, re-denominated into a large number of smaller-value tradeable contracts and sold into the bond market.
Self regulated market risk	assumption regards over-reliance on indicator systems and implicitly the devaluing of personal and empirical experience of risk-taking. This may be described as the "models assumption". In the UK banking sector, it refers to

regulators' belief – or hope – that control systems are effective as long as they are well-populated by market-derived risk models.

Sense-making		A term from organizational behavioural science, pioneered by Karl Weick (1995, etc.), following a theory by Starbuck and Milliken (1988). Faced with unclear or complex information or instructions, “incongruous events that violate perceptual frameworks”, people will resolve the tension by constructing their own interpretations. “Perceptions and actions [then] validate one another”, with the whole organization adjusting its own “fit” with reality and its environment.
Shadow banking		A term coined by the US Federal Reserve in 2010 for products which trade outside the licensed jurisdiction of banking – including hedge funds (see separate entry). May account for a market worth more than the value of the entire licenced market.
Short-term markets	money	A market, local to each major financial centre, in which financial institutions can trade large volumes of short-term debt and securities at preferential (“money market”) local rates of interest available only to participating institutions.
Solvency		Ability to pay debts when they fall due for payment; hence also, a technical measure of the extent to which an organization has this ability (the “solvency ratio”). If a company becomes “insolvent”, it owes more than it owns - so will not be able to pay its debts, and must be shut down.
Stocks		Generic name for securities; that is, certificates for shares representing part ownership of a business, or a part share of a loan to a business.
strategic ignorance		To gain comfort from redefining certain threats as less immediate, either at a cognitive level (as with hindsight bias [Fischhoff, 1982]) or by rearranging their information systems so as to suppress discomfoting data (McGoey's [2007])
Stress Testing		Highly formalised risk calculation tools used in econometric analysis
Sub-prime		Mortgage lending to borrowers who have had past credit problems (payment delays, defaults or bankruptcy). Offers a higher risk/return ratio (the borrowers are more likely to default, but as a result they can be charged higher rates of interest). A volatile market, as the potential for greater profits is at odds with low-income borrowers' high vulnerability to any rise in interest rates.
Systemic stability		(Technical definitions vary between various nations' central banks. However, as a generic definition:) <ul style="list-style-type: none"> - Tolerable probability of failure of any individual financial institution; and - Tolerable losses in the event of any institution failing; and - A tolerably low level, and evenly distributed nature, of interconnected trading activity between institutions, so that failure of any one institutions does not trigger failure of others

Table of Eleven / Tafel van Elf	<p>A tool for policy developers and drafters to conduct ex ante testing of proposed legislation, offering a rating of expected compliance extrapolated from measures of “the objective and/or subjective perception of a specific rule by a specific target group”. Developed for the Dutch Government by Prof. Dick Ruimschotel (Erasmus University). An interactive version of the tool includes data management, checklists for legislators and a "motives-for-compliance test", producing a Compliance Estimate. A 60-item legislator checklist gives policymakers a first impression of the extent to which proposed legislation may be expected to be complied with; this is followed by detailed tests for feasibility and enforceability. The motives-for-compliance test offers enforcement agencies an indication of the motives of the target group for complying with a rule, identifying the rule's weak and strong points for according to the target group and giving early warning of problem areas. Finally a Compliance Estimate highlights types of persons most likely to be compliant or non-compliant.</p> <p>Source: Dutch Government: Justitie (Ministry of Justice) at: http://www.it11.nl/it11/login.jsp?page=2</p>
Tripartite supervision	<p>The system of UK banking regulatory agency created by Gordon Brown (when Treasury minister). Three bodies shared responsibility for oversight of banking: HM Treasury, the Bank of England, and the Financial Services Authority. Each had lead responsibility for different aspects of banking practice. A government review of the perceived failings of this system in June 2008 is reported to have the effect of increasing the Bank of England's authority and removing some elements of agency from the FSA.</p>
Value-At-Risk modeling	<p>Risk model which assumes for the purposes of regulation that a product's risk may be fully determined by the underlying value of its contract at a particular moment in time (such as the day of an annual audit). One of the highly formalised, and hence highly manipulable, risk calculation tools used in econometric analysis.</p>
Virtualised products	<p>Financial products such as certain forms of derivatives, purchased on trust more than as a result of financial analysis.</p>
Wraps, wrap platforms	<p>Web-based portfolio administration services allowing financial advisers (and sometimes unadvised investors) to view and administer a portfolio of investments.</p>

Sources: Oxford Dictionary of Banking; The Economist Guide to the City; author's own *Bankfacts* (series published when at British Bankers' Association).

ANNEX 4: SUMMARY TIME-LINE AND CASE NOTES: RECENT (ILLUSTRATIVE) MARKET SHOCKS AFFECTING PUBLIC PERCEPTION OF REGULATORY CONTROL IN THE UK

4A: SUMMARY TIMELINE – case details in 4B following

1978 – 1996 – Insider trading frauds by “names” at Lloyds of London (insurance market)

1984 – Midland Bank / Crocker takeover

1984 – Johnson Matthey fails

1986 – Morgan Grenfell, Ansbacher and Cazenove: Guinness/Distillers bid fraud

1988 – Barlow Clowes investor fraud

1989 – Hammersmith and Fulham Council massive losses on derivatives

1990 – British and Commonwealth acquires a fraudulent broking business

1991 – Bank of Credit and Commerce International revealed as a bank for criminals

1992 – Maxwell Communications defrauds its pension fund

1993 – European Bank for Reconstruction and Development corruption

1994 – Pensions misselling revealed in 349 firms: £12bn compensation paid out

1994 – 2002 Rogue traders destroy Kidder Peabody, Barings, Daiwa, Sumitomo, Allied Irish banks

1995 – Barings Bank falls to a rogue trader

1996 – Morgan Grenfell Asset Management: worthless product marketed by fund manager discovered to be insane

1998 – Credit Suisse First Boston discovers “Flaming Ferraris” corrupt trader team

1998 – Long Term Capital Management hedge fund fails

1999 – Equitable Life bankrupted by its own product promises

2000 – NatWest Capital Markets trade risk reporting fraud destroys its parent company

2001 – Marconi’s capital wiped out by Board-level failure of risk governance

2002 – Split-capital Investment Trusts revealed to be a front for insider trading

2003 – High risk “Precipice Bonds” mis-sold to retail investors

2005 – Credit Suisse First Boston bank’s compliance officer revealed as major fraudster

2007 – Northern Rock bank collapse

2008 – Societe Generale seeks to blame £3.7bn loss on a single rogue trader

2008 – Collapses of Bear Stearns, Lehman Brothers, Merrill Lynch banks and American International Group insurance (US), HBOS and Alliance & Leicester banks and Bradford and Bingley building society (UK), Anglo Irish and Allied Irish banks (Eire), Glitnir, Kaupthing and Landeskreditbank (Ireland), Roskilde and (Denmark) and others, following overselling of mortgage-related contracts (“subprime”). UK high street banks nationalised.

2008 – Collapse of Royal Bank of Scotland following acquisition of failing ABN AMRO bank

2008 – Bernie Madoff’s investment house revealed as largest-ever pyramid selling (Ponzi) scheme

2010 – Greek banks and national economy fail after over-borrowing

Annex 4B:

MARKET SHOCKS AFFECTING PUBLIC CONFIDENCE IN REGULATION

Summary case notes on incidents and consequences

1984: **Midland Bank** (Crocker Bank takeover): A UK bank acquired a US bank subsequently hit by a Latin American debt crisis. £1 billion was lost, and Midland was taken over, possibly technically insolvent.

1984: **Johnson Matthey**: A bullion dealer expanded into commercial loans, which failed. The Bank of England's attempts to arrange a "lifeboat" rescue by commercial banks was rejected by them. The Bank of England was accused of negligence. In response, the Banking Act 1987 expanded the Bank of England's supervisory remit.

1986: **Morgan Grenfell** (and advisers Ansbacher, Cazenove): Guinness takeover bid for Distillers: The Guinness corporation participated in an illegal scheme to artificially inflate its own share price and thereby make its bid for Distillers, a rival, more attractive, indemnifying the buyers against any loss. Ernest Saunders, the chief executive of Guinness, was jailed for five years. Another businessman and a trader were jailed for theft and false accounting, and a financier fined £4m. The trial of executives of merchant bankers Ansbacher and Morgan Grenfell collapsed, and charges against an executive of Cazenove, the broker, were dropped.

1988: **Barlow Clowes**: A bogus fund manager stole £150m savings from elderly investors after marketing a "too good to be true" investment promise. HM Government admitted regulatory maladministration (via DTI) and paid net compensation of £74 million.

1989: **Hammersmith & Fulham Council**: A local authority treasurer trying to boost funds by playing the derivatives market lost £500m of ratepayers' money. 78 other local authorities were then found to be exposed to similar market risks. House of Lords ruled that all the transactions were void (because the treasurers had acted *ultra vires* – outside their professional remit), leaving the advisor banks to pay off £750m on more than 1000 annulled contracts. (A similar incident occurred when Orange County, California, bankrupted itself following a \$1.6 billion bad trade in derivatives.)

1990: **British & Commonwealth Holdings** (and advisers BZW): Financial holding company acquired a money broker without fully noticing "irregular accounting practices" which compromised its value. The deal's advisers BZW paid £116m compensation for failing to exercise "due diligence".

1991: **Bank of Credit and Commerce International (BCCI)**: A London-headquartered Shia Muslim bank exported its massive trading losses (\$849m) off UK balance sheet into offshore subsidiaries. Creative accounting, theft of deposits, and money laundering for various global drug barons, arms traders and kleptocratic regimes added up to what was reported at the time to be the biggest bank fraud in history. An offer to launder money for an undercover US Federal Agent in Miami led to prosecution and foreclosure on 150,000 depositors. 25% of all money deposited had disappeared (\$2 billion). Analysts noted that BCCI "demonstrated how criminally-minded international bankers could outwit regulators and accountants with national remits". A spur to the setting up of the global Financial Action Task Force, a group of central and commercial banks and the governments of the world's leading economies acting to combat money laundering.

1992 – **Maxwell Communications Corp.** (and advisers Pricewaterhouse Coopers, Goldman Sachs): City "buccaneer" Robert Maxwell funded grandiose acquisitions by forging profit figures, stealing from his employees' pension funds, and continually moving cash around between accounts to conceal its extent and origins. All this was revealed when he died, probably as a suicide. Advisers were said to have had "had their vision clouded by fat fees"

and the auditors, accused of having “lost the plot”, paid a £67m settlement and £3.4m fine. Defrauded pensioners’ anger was compounded by professional fees of £30m paid to advisers on the receivership – pronounced “shameful” by the High Court judge in the case.

1993 – European Bank for Reconstruction and Development: The EU and US funded a new bank designed to assist new eastern European countries’ transition to market economies. Audit revealed that three years after its foundation (in 1990) it had spent twice as much money on housing itself (£200m) as on the loans it was supposed to be making – including a massive marble-lined London headquarters. Directors were ousted and business has since continued more normally.

1994 – Pensions mis-selling by Prudential, Royal & Sun Alliance, and 347 other firms: In 1988, wanting to encourage people to save for their old age, the Government had intervened to open up a market for personal pensions. Many commission-driven pension sellers regarded this as an opportunity to persuade people to leave perfectly adequate employer schemes and convert to their private schemes. The “clear-up” continued more than 10 years later, with 349 pension provider businesses disciplined by the FSA, £11million in fines and £12billion in compensation payments.

1995 – Barings Bank and Barings Securities: The Board of this venerable, medium-sized London bank employed a trader they believed to be gifted to set up a new derivatives trading operation in Singapore. The trader, Nick Leeson, was unqualified to deal in options and a gambling addict. He booked losses of £342million to a concealed “error account”, while reporting fictitious profits of £40 million. Barings awarded him large cash bonuses and continued to support his “amazing” performance by providing £500m – more than half the value of the bank itself – in margin payments (in effect, stake money). After the Kobe earthquake in January 1995 demolished his bets on Japanese market recovery, Leeson took a “double-or-quits” gamble for \$7bn and fled; the bank duly collapsed. The Bank of England was keen for the commercial banks to rescue Barings (to avoid BoE’s moral hazard in bailing it out itself) but the banks refused to help – a significant turning-point in relations with the regulator. Barings’ directors were criticised for being “absurdly amateurish and complacent” and for the “total collapse of management control” in supporting Leeson’s activities. The Barings collapse is widely regarded as the point at which the Bank of England forfeited the right to supervise banking, and a catalyst for the creation of the FSA on the arrival of a new Labour government in 1997.

1994 – 2002 Rogue traders at Kidder Peabody (\$350m), Daiwa (\$1.1bn), Sumitomo (\$3bn), Allied Irish Banks (\$750m): Over nearly a decade a series of highly motivated rule-breakers created record losses on individual trading activity. They may be seen as either criminal opportunists or perverse-consequence victims of the banks’ “star trader” system, which during those years rewarded extreme risk-taking. A significant regulatory outcome was the introduction of supervision based on Value at Risk (VaR) modelling and regulation (including FSA) which expressly makes a virtue of intervening in proportion to the risk being taken.

1978 – 1996 Lloyds of London insider trading by “Names” (“baby syndicates”): Formerly run as a form of private members’ club for people wanting to gamble on insured risks, Lloyd’s began to face lawsuits over liability for large losses and in 1982 an Act of Parliament attempted to impose modern corporate governance. But in 1982 one underwriter implicated in a \$55m fraud was acquitted and another who carelessly lost £130m was sued for stealing funds from his backers (the “Names”). On taking up office in 1983, Lloyd’s first CEO uncovered rampant insider trading, with preferential trades among senior members of the market siphoning off £100m of investors’ funds annually. Yet the market continued to expand, bringing in commercial (as opposed to private-investor) funding until 1987, when a series of massive liabilities and £8billion in catastrophe losses laid bare the market-makers’

“incompetence and indifference”. The Names sued, receiving a £3.2billion settlement, and Lloyd’s was forced to reconstitute with full corporate governance.

1996 – Morgan Grenfell Asset Management (unit trusts): A highly-regarded fund manager and mathematical genius succumbed simultaneously to temptation and to serious mental illness. Shortly after winning a “Fund Manager of the Year” award, Peter Young made a series of unlicensed investments in minor high-tech companies and inflated the values of these investments in MGAM’s accounts. The stocks were in fact worthless. Despite a £2m fine from the regulator, a £10m public prosecution of MGAM collapsed, with Young judged unfit (through insanity) to stand trial and three other managers acquitted on technicalities.

1998 – Credit Suisse First Boston: “Flaming Ferraris” trader team: A flamboyant group of young equity traders specialising in index arbitrage (a form of computer-driven speculation) hired a publicist to try to boost their claims to a performance bonus. Buoyed up by the resulting media coverage, one of the traders, MP’s son James Archer, made insider trades from a mobile phone in an attempt to “ramp” his personal performance with his employer. The Swedish company whose shares he traded detected the fraud. The Swedish regulator fined CSFB; the UK regulator suspended Archer, and two managers who failed to supervise him, for life.

1998 – Long Term Capital Management: This hedge fund made arbitrage trades with a very high level of gearing (\$4bn of actual capital sustaining \$200bn of investments). Its ingenious trading model at first yielded spectacular profits, and investors piled into the fund with exemplary “optimism bias” (the “irrational exuberance” noted by the US central bank chief Alan Greenspan). However, LTCM had a large exposure to the growth of “developing markets”, notably including Russia. The fund suddenly fell \$2.1bn short of the capital required to fund its margin calls after Russia’s shock devaluation of the rouble and suspension of international debt repayments in August 1998. LTCM’s highly academic trading model, supervised by a prominent Board of Management, failed to take account of certain potential real-world changes in the fundamental value correlations between markets (such as a currency devaluation). With capital inadequate to cover its market obligations, LTCM collapsed, generating \$200bn “contagion” losses.

1999 – Equitable Life and its guaranteed annuities: During the high-inflation, high-interest-rate markets of the 1970s and 1980s, the UK’s second-largest provider of pensions and life assurance had set up products which guaranteed around a 12% annual payout on investments to 90,000 of its 1million customers, many of whom were high-earning individuals. When in the 1990s markets subsided into low inflation and interest rates, Equitable found it could no longer afford to pay the “guaranteed” returns to these customers and asked its lawyers to seek a release from its guarantees. Customers sued for breach of contract and the courts agreed. Equitable suspended new business, cut its payouts to non-guarantee customers, and was sold, in a complex rescue package entailing £0.5billion of written-off liabilities, to Halifax bank.

2000 – NatWest Capital Markets: unreported losses following mispriced trades in options: Repeated warnings from internal and external auditors about lack of controls on reporting of trades had passed unheeded for three years. Meanwhile a £90.5million “black hole” stood, undisclosed or possibly even unnoticed, on the trading book after two traders overstated valuations of their dealings in order to conceal the loss. NatWest’s other dealers were forced to forfeit their bonuses (£8million+) to make good the loss; the FSA imposed £420,000 in fines and suspended the traders involved; the control failure cost several senior executives their jobs; and the parent company (NatWest) was sold following a hostile takeover bid.

2001 – Marconi failure of risk governance: One of the world’s largest electronics businesses, the former General Electric Company destroyed its own capital value, which collapsed from £35billion to £1billion in a single year, by acquiring a string of technology companies the year the dotcom/ telecomms technology market bubble burst. Following a timidly announced

profits warning, shareholders evicted the Board but then had little choice but to support a rescue package which reduced share value still further; share price fell from a historic high of £12.50 to just 4 pence. The collapse of Marconi was a significant motivator of calls for more transparent corporate risk reporting in the 2000s.

2002 – Split-capital investment trusts: Sold since the 1960s, these products had promised investors either high income and or strong capital growth, according to their needs and preferences. 50,000 private investors had bought them by the time nearly half of all split-cap funds ran into difficulties as a result of overgearing (unsustainable borrowing to fund purchases). The FSA's biggest investigation to date revealed that 17% of the value of split caps was accounted for by fund managers who had been supporting each others' fund values by trading among themselves.

2003 – “Precipice bonds” mis-selling: Lloyds TSB fined: The FSA fined Lloyds TSB a record £1.9million and extracted £98million in customer compensation for the bank's mis-selling of bonds which guaranteed 10% return only for as long as markets could support this return (thereafter the interest payable would “fall off a cliff” – hence the bonds' nickname). The FSA used the occasion of the fine to announce a new intention to drive out any “persistent malfunctioning of the market” through mis-selling.

2005 – Credit Suisse First Boston: fraud by compliance officer: Asif “The Walrus” Butt, a compliance officer, was jailed following a series of share trades made by old school friends, whom he had tipped off shortly before market announcements. The reported loss was £265,000 but it was believed that Butt had made as much as £2m for himself at investors' expense. The trial judge highlighted the “severe damage” done to investors' confidence in systems of oversight.

2007 – Northern Rock: This UK mortgage bank had pursued a growth strategy which relied for more than 77% of its funding on short-term debt issued in the capital markets, rather than on customer deposits. On 9th August 2007, this funding source evaporated as the US “sub-prime” mortgage market crashed. British customer anxiety was heightened by a well-known shortfall in protection for deposits – at the time, only deposits up to £31,700 were guaranteed. Following disclosure on 7th September by BBC News³⁸ that “a high street bank” was in trouble, the Bank of England publicly stepped in to save Northern Rock as “lender of last resort”, and HM Treasury offered an emergency deposit guarantee. This action contradicted the BoE's stated principle of avoiding moral hazard, although it claimed that the “penalty rate” of its emergency funding offset this. The banking industry's advocacy group, the BBA, in a rare acknowledgement of the power of news media to amplify panic, urged the media and the public to “calm down”.

Similarly to the Barings case,(1995), all 12 of the European banks initially approached to buy out Northern Rock declined. In succeeding months the Government was criticized for allowing some commercial rescue offers to lapse, increasing the risk that the Rock could only be rescued through nationalisation, a politically embarrassing option for HM Treasury and

³⁸ The BBC's decision to support the its business editor, Robert Peston, in publicising Northern Rock's covert approach to the Bank of England, was itself controversial; some bankers accused the BBC of inducing panic. BBC head of news Peter Horrocks justified the leaking of the story thus: “Announcing to an unsuspecting public that a major high street name appeared to be in trouble obviously ran the risk of causing depositors to panic and withdraw their funds. ...We broke this dramatic news in a responsible fashion, explain[ing] the causes of the crisis in a way that audiences unfamiliar with financial markets would understand. But is it the BBC's job to tell people to be calm and advise them what to do? We are not financial advisers... We judge it is right for us to report the reassurance being offered by the Bank of England and the FSA and our correspondents have offered the judgement that those reassurances are legitimate. But it's not the BBC's job to tell the audience what to do with its money.” (BBC Editors' blogspace, 14.9.07: http://www.bbc.co.uk/blogs/theeditors/2007/09/preventing_panic.html)

the regulatory system in general. However, Northern Rock was not seen as “Too Big To Fail” and entailing systemic risk, unlike the SocGen case, next below).

2008 – Société Générale (SocGen) bank: risk control system hacker / rogue trader: Unlike Barings or Northern Rock, SocGen is one of its host country (France’s) largest commercial institutions. As a national retail bank and significant in global markets, it is in a category of super-banks known as “TBTF” (Too Big To [be allowed to] Fail). SocGen employee Jérôme Kiervel, a novice trader allegedly acting alone, for a year ran a “concealed enterprise”. Having previously worked as a clerk in the bank’s back office, Kiervel used his knowledge of reporting systems to regularly disable the bank’s risk-control software, enabling him to run up €30billion of exposure to open futures contracts. The fraud was discovered when Kiervel neglected to override one of the exposure alarms. Coincidentally, the next trading day (January 21st) saw the largest stock market fall in 25 years.

Although SocGen had alerted its regulators, the bank was allowed to conceal news of the fraud from the markets for three days, to minimise the onward costs of “contagion” whilst it attempted in private to unwind Kiervel’s exposure. By the time SocGen revealed its “terrifying accident” to the markets three days later, it had reduced the directly related losses to €5billion (£3.7billion), on top of its €2billion losses incurred during the sub-prime collapse in the preceding weeks. Despite the chairman’s protests, few market watchers believed that Kiervel could have been acting alone; lawyers acting for SocGen shareholders said that if he had done all the damage entirely by himself, Kiervel “deserved a medal for ingenuity”.

2008 – Bear Stearns: This venerable US-based investment bank and securities trading brokerage was founded in the 1920s. During the US mortgage boom it issued large quantities of asset-backed securities, and over 2006 and 2007 it increased its exposure, especially to the US mortgage-backed securities central to the so-called ‘subprime mortgage crisis’. Drastic falls in the prices of previously highly-rated assets led to the failure of two large hedge fund subsidiaries in summer 2007, followed by widely-predicted collapse. An emergency loan from the Federal Reserve Bank in March 2008, could not save the company, and Bear was sold to JP Morgan Chase for \$10 per share. JP Morgan ceased using the Bear Stearns name in 2010.

2008 – Lehman Brothers: UK-based accounting fraud: The fourth-largest investment bank in the USA, founded in 1850, Lehman had global business in financial services including private equity and fixed income sales and trading. The credit ratings downgrade of assets in which it held very large positions, and the consequent collapse of client confidence, triggered a filing for Chapter 11 bankruptcy protection in September 2008. The Bankruptcy Examiner prominently reported its use of a window-dressing accounting practice known as “Repo 105”, technically permitted in the UK but not in the US, through a UK subsidiary. This raised important questions on the management of global bankruptcies and the transfer of assets, and the possibility of an orderly bankruptcy for a global firm.

2008 – AIG: American International Group had entered into Credit Default Swaps insuring enormous volumes of highly-rated asset-backed securities, including subprime mortgage backed securities. The downgrade of these assets and of its own rating forced the company to offer guarantees to creditors and counterparties. The Federal Reserve provided a secured loan of up to \$US85 billion to prevent bankruptcy in September 2008, and took a 7.79% equity stake. Controversy arose from further loans and post-bailout expenditures, especially on employee bonuses, and from the large sums paid through AIG to global financial institutions who had already received taxpayers’ support, and those outside the USA.

2008 – HBOS: This bank was the product of a 2001 merger between Halifax bank and the Bank of Scotland, forming a fifth bank comparable in size to the big four UK retail banks at that time. In September 2008, HBOS suffered volatility and a collapse in its share price following the collapse of Lehman, a loss of confidence, and rumours that it has asked the Bank of England for emergency funding. HBOS became a wholly owned subsidiary of the

Lloyds banking group, HM Government allowing the merger to bypass competition law. There was much speculation about the role of short-selling in precipitating the merger, but in February 2009, Lloyds revealed losses of £10bn at HBOS. In March 2009, the UK government increased its stake in Lloyds Banking Group from 43% to 65%.

2008 – **Bradford and Bingley** had converted from a building society to a bank, and floated on the London stock market, in 2000. It then abandoned standards in lending, making more than 80% of its mortgages to borrowers self-certifying their income or buying to let. During the financial crisis, its ability to obtain funding on the international markets disappeared. In the understandable absence of any interest in a takeover, Bradford and Bingley was nationalised by the UK government at the end of September 2008. Its retail operations and branch network were sold to Grupo Santander.

2008 – **Royal Bank of Scotland**: In April 2008, RBS announced a rights issue intended to raise £12bn to offset £5.9bn losses from credit markets and to increase reserves following the purchase of ABN AMRO. In October 2008, in the absence of other subscribers to a further rights issue, HM Government took a stake of more than 57% of the share capital as part of operations to avert collapse of the financial sector. The chief executive, Sir Fred Goodwin, resigned. In January 2009 the government converted its preference shares to ordinary shares, resulting in an increase of its equity stake to 70%. On the same day, RBS announced full-year trading losses of between £7bn and £8bn, and writedowns on goodwill, mainly the disastrous takeover of Dutch bank ABN AMRO, of about £20bn.

2008 – **Irish banks** and the property crash: The collapse of a nationwide property bubble, low lending standards, and fraudulent circular transactions triggered enormous losses to Ireland's major banks on commercial and residential real estate loans. In September 2008, the government of Ireland, which was not in deficit before the crisis, guaranteed all liabilities of its biggest banks, exceeding 200% of Ireland's GDP. In December 2010 Ireland took an €85bn IMF-sponsored rescue package intended to restore confidence and stability. The conversion of private liabilities to public necessitated a severe government austerity programme. In 2008-9 Ireland's economy contracted by 11%, and unemployment rose to more than 13% of the labour force.

2008 – **Icelandic banks in the UK**: Iceland's three major commercial banks, Glitnir, Kaupthing, and Landsbanki, expanded massively then fell into debt default and receivership. Large-scale fraud and false accounting were found, with connected-party loans and own-share transactions as well as investment losses. The UK had been a prominent base for the banks' expansions (for example, Landsbanki created a UK brand, IceSave). Creditors and depositors of subsidiaries outside Iceland sought or received substantial assistance from national governments, and a \$4.6 billion IMF-led loan was extended to the government of Iceland. In the UK, the government invoked anti-terrorism legislation to freeze assets, and guaranteed the deposits of UK retail investors. A proposal to for the Icelandic government to reimburse this money was rejected in a referendum on 11th April 2011. The Icelandic economy reacted sharply, with national currency devaluing and fierce rises in interest rates, inflation and unemployment.

2008 – **Nationalisation of UK banks**: A £500bn rescue package for the UK banking system was announced in the first week of October 2008, consisting of short term loans and guarantees of debt. This failed to restore confidence or restart lending between banks, but had the effect of making all of Britain's high street banks (except for HSBC) partly or wholly state controlled.

2008 – **Madoff**: massive fraud by 'wealth management' institution: Investment manager Bernard Madoff was arrested, and subsequently jailed for life, after confessing to his sons that his wealth management business, in operation since the 1970s, was based on a fraudulent ("Ponzi") scheme. Its marketing relied on "affinity fraud", using social contacts to attract

money from charities, private investors, and the rich and famous. Madoff also ran a large broker-dealer business and had been the Chairman of a major US stock market, NASDAQ. This case was remarkable for submissions of evidence to the US securities regulator (SEC) in May 1999, and again in 2005, by Harry Markopolos, a derivatives expert and trader. Markopolos argued forcefully that the most rational explanation for Madoff's returns was that he was running a Ponzi scheme. The fraud was officially valued at US\$64.8bn; investors had paid in (and lost) US\$36bn. Investors sued the trustees and Madoff's main adviser banks including JP Morgan Chase and HSBC for return of fees and for complicity.

2010 – Investment banks enabled Greece to over-borrow: The Greek economy grew rapidly in the early 2000s, fuelled by cheap borrowing in Euros, much of it organized by investment banks. In 2010 it became apparent that the Greek government had engaged in transactions designed to hide the true level of borrowing. Tax evasion was already a severe and widespread problem, and the severe austerity measures required by IMF bailouts caused civil unrest. Subsequently, the eurozone countries and the International Monetary Fund have agreed a further series of rescue loans, conditional on a new Greek government's implementation of harsh austerity measures.

2011 – Report of the UK's Independent Commission on Banking: Appointed by the UK Parliament, this body published (in April 2011) a report recommending ring-fencing of retail banking operations, and a requirement of 10% equity capital applying both to a retail banking subsidiary and to the group as a whole. It stopped short of recommending actual breakup of universal banks, holding that the costs of this would outweigh the benefits. A week later, the Public Accounts committee report on the progress of taxpayer support for the UK banking system: Although banks had repaid nearly half of the £1trillion of public money used for their rescues, they reportedly continued to expect public support; also, the mechanisms for winding up a failed bank could not handle failure of a major institution, which would still transfer costs from shareholders and creditors to the public.

All case notes summarised from commercial market analyst reports (Economist Intelligence Unit, Technometrics), contemporary news media accounts (Financial Times, [London] Times, BBC News), Exeter University financial markets history web resource (<http://www.projects.ex.ac.uk/RDavies/>) and author's own recollections. Any errors of fact or inference are the author's own.

ANNEX 5: INTERVIEWEES (ANONYMISED)

<i>Research identity</i>	<i>Role function / title</i>	<i>Organization description</i>	<i>Pilot</i>	<i>Main 1</i>	<i>Main 2</i>
C1	CRO, Head of Audit; Principal of a trade association	Major retail financial brand; Major industry NGO	X	X	
C2	CRO, Managing Director	Global investment bank, EMEA HQ, London	X	X	
SM1	Director, risk product development	Global bank, London HQ	X	X	
SM2	Director, government relations; Head of a trade association working group	Major retail financial brand	X	X	
TA1	Director, Risk	Major industry NGO	X	X	X
ADV1	Director, regulatory relations	Professional advisory firm	X	X	
ADV2	Director, regulatory affairs	Professional advisory firm	X	X	
ADV3	Director, regulatory relations; head of a trade association working group	Professional advisory firm; Major industry NGO	X	X	
ADV4	SVP, regulatory relations	Professional advisory firm	X	X	
ADV5	Managing Director, risk advisory	Analytics	X	X	
C3	CRO, Director	Global investment bank, EMEA HQ, London	X	X	
ADV6	Senior Manager, Risk	Professional advisory firm	X	X	
SM3	Chairman, Risk Committee; Head of a trade association working group	UK high street bank; Major industry NGO	X	X	
C4	CRO, Director regulatory relations; Head of a trade association working group	Major retail financial brand; Major industry NGO	X	X	X
C5	CRO, Head of Risk	UK high street bank	X	X	X
C6	CRO, Head of Risk	Global bank, UK (wholesale market) HQ		X	
TA2	AD, regulatory relationships	Major industry NGO		X	
C7	CRO	International bank, UK HQ		X	
C8	CRO, Managing Director	International bank, UK HQ		X	
C9	CRO, Managing Director	Global bank, EMEA HQ, London		X	
C10	CRO	International bank, UK HQ		X	
C11	CRO, Retail	Major UK mortgage bank		X	X
C12	CRO, Head of Group Credit and Risk	Global bank, London HQ		X	
C13	CRO	Global bank, UK (wholesale market) HQ		X	
C14	CRO	Global bank, EU HQ		X	
C15	CRO, Manager Group Credit and Risk	Major UK mortgage bank		X	
C16	CRO, Head of Audit	UK private bank		X	
C17	CRO	International bank, EU HQ		X	
C18	CRO	International bank, UK HQ		X	X
C19	CRO, Wholesale	Major UK mortgage bank		X	
C20	CRO	UK private bank		X	
C21	CRO, Director Risk	International bank, EU HQ		X	

C22	CRO	International bank, EU HQ		X	
C23	CRO	International bank, UK HQ		X	X
C24	CRO, Head of Risk	Major UK high street bank		X	X
C25	CRO, Director Market Risk	Wholesale banking division of high street brand		X	
C26	CRO	International bank, UK HQ		X	
C27	CRO	International bank, UK HQ		X	X
C28	CRO, Head of Global Operational Risk	International bank, UK HQ		X	
C29	CRO, Head of Regulatory Risk	UK high street bank		X	
C30	CRO, Director of Risk	UK high street bank		X	
REG1	Head of Risk regulation	Regulator (former banker)		X	
C31	CRO	International bank, UK HQ		X	
C32	CRO, Director, Group Risk	UK mortgage bank		X	
C33	CRO	International bank, UK HQ		X	
C34	CRO, Director of Group Operational Risk	UK high street bank		X	
C35	CRO	International bank, UK HQ		X	
		Total	15	47	8
		Grand total interviews			70

Assumptions for table

- *CRO status verified by one or more of the following means: respondent's own confirmation; BBA member listing / attendance at CRO forums; other CRO (colleague) verification.*
- Brief guide to distinguishing bank and business types:
 - Global bank - active in all major centres of business worldwide
 - International bank - active in more than one country
 - High street bank - deposit-taking and servicing for individual customers and local businesses
 - Private bank - deposit-taking for individual wealthy customers
 - Retail banking - providing "non-expert" financial services, subject to full consumer regulation; mainly, taking individuals' deposits and lending cash to individual and small-business borrowers
 - Wholesale banking - providing professional market services which exclude consumer access; includes raising funds through the money markets
 - Investment banking - buying and selling stakes in business ventures (as opposed to simply lending cash to borrowers)
- Interviewee coding:
 - Cxx = CRO;
 - SMxx= Board-level senior manager with responsibility for business risk;
 - ADVxx=Non-banker professional adviser with risk reporting brief (lawyer, auditor, analyst, rating agent);
 - TAxx=Director/principal convenor of an industry trade association
 - REGxx=Regulatory agent (and former risk officer).